(14)

No. 96-842-CFY Title: United States, Petitioner
v.
James Herman O'Hagan

Docketed: November 26, 1996 Court: United States Court of Appeals for the Eighth Circuit

Entry	Date	Proceedings and Orders
	Nov 26 1996	Petition for writ of certiorari filed. (Response due December 30, 1996)
	Nov 26 1996	Appendix of petitioner filed.
	Dec 24 1996	Order extending time to file response to petition until December 30, 1996.
	Dec 30 1996	DISTRIBUTED. January 17, 1997
	Dec 30 1996	Brief of respondent James Herman O'Hagan in opposition filed.
	Jan 7 1997	Reply brief of petitioner United States filed.
	Jan 17 1997	Petition GRANTED. The brief of petitioner is to be filed with the Clerk and served upon opposing counsel on or before 3 p.m., Friday, February 28, 1997. The brief of respondent is to be filed with the Clerk and served upon opposing counsel on or before 3 p.m., Friday, March 28, 1997. A reply brief, if any, may be filed with the Clerk and served upon opposing counsel on or before 3 p.m., Wednesday, April 9, 1997. Rule 29.2 does not apply. SET FOR ARGUMENT April 16, 1997. **********
	Feb 11 1997	Record filed.
	Feb 18 1997	Record filed.
	Feb 27 1997	Brief amicus curiae of American Institute of Certified Public Accountants filed.
	Feb 27 1997	Joint appendix filed.
	Feb 27 1997	Brief of petitioner United States filed.
	Feb 28 1997	Brief amici curiae of North American Securities Administrators Assn. Inc. et al. filed.
	Feb 28 1997	Brief amici curiae of Association for Investment Management and Research filed.
	Feb 28 1997	CIRCULATED.
	Mar 27 1997	Brief amici curiae of Law Professors and Counsel filed.
	Mar 28 1997	Brief of respondent James Herman O'Hagan filed.
	Mar 28 1997	Brief amicus curiae of National Association of Criminal Defense Lawyers filed.
	Apr 9 1997	Reply brief of petitioner United States filed.
	Apr 16 1997	ARGUED.

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In the Supreme Court of the United States

OCTOBER TERM, 1996

UNITED STATES OF AMERICA, PETITIONER

v.

JAMES HERMAN O'HAGAN

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether respondent's trading of securities on material, nonpublic information that he misappropriated in breach of his fiduciary duties violated Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5.

2. Whether the Securities and Exchange Commission validly exercised its rulemaking authority under Section 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. 78n(e), in promulgating Rule 14e-3, 17 C.F.R. 240.14e-3, an insider trading rule relating to tender offers.

3. Whether respondent's trading in securities on material, nonpublic information that he misappropriated in breach of his fiduciary duties violated the mail fraud statute, 18 U.S.C. 1341, even if his conduct did not violate the securities laws.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	2
Statutes and rules involved	2
Statement	3
Reasons for granting the petition	10
Conclusion	25

TABLE OF AUTHORITIES

Cases:

Carpenter v. *United States*, 484 U.S. 19 (1987)	13, 16, 20, 21, 22, 24
Chevron U.S.A. Inc. v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984)	18
Chiarella v. *United States*, 445 U.S. 222 (1980)	11, 12, 16
Dirks v. *SEC*, 463 U.S. 646 (1983)	11
Pereira v. *United States*, 347 U.S. 1 (1954)	22
Rothberg v. *Rosenbloom*, 771 F.2d 818 (3d Cir. 1985), cert. denied, 461 U.S. 1017 (1987)	15
Schreiber v. *Burlington Northern, Inc.*, 472 U.S. 1 (1985)	18, 19
SEC v. *Boesky*, Fed. Sec. L. Rep. (CCH) ¶ 92,991 (S.D.N.Y. 1986)	23
SEC v. *Cherif*, 933 F.2d 403 (7th Cir. 1991), cert. denied, 502 U.S. 1071 (1992)	12, 15
SEC v. *Clark*, 915 F.2d 439 (9th Cir. 1990)	15
SEC v. *Drexel Burham Lambert*, Fed. Sec. L. Rep. (CCH) ¶ 94,474 (S.D.N.Y. 1990)	23
SEC v. *Levine*, No. 86 Civ. 3726 (S.D.N.Y. 1986)	23
SEC v. *Maio*, 51 F.3d 623 (7th Cir. 1995)	19
SEC v. *Materia*, Fed. Sec. L. Rep. (CCH) ¶ 99,526 (S.D.N.Y. 1983), aff'd, 745 F.2d 197 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985)	13, 15, 17, 23

Cases—Continued: Page

SEC v. *Milken*, Fed. Sec. L. Rep. (CCH) ¶ 95,200 (S.D.N.Y. 1990) 23-24
SEC v. *Musella*, 578 F. Supp. 425 (S.D.N.Y. 1984) 23
SEC v. *Peters*, 978 F.2d 1162 (10th Cir. 1992) 19
SEC v. *Tome*, 638 F. Supp. 596 (S.D.N.Y. 1986), aff'd, 833 F.2d 1086 (2d Cir. 1987), cert. denied, 486 U.S. 1014 (1988) 23
SEC v. *Vaskevitch*, 657 F. Supp. 312 (S.D.N.Y. 1987) 23
United States v. *Bryan*, 58 F.3d 933 (4th Cir. 1995) 15, 21
United States v. *Chestman*, 947 F.2d 551 (2d Cir. 1991), cert. denied, 503 U.S. 1004 (1992) 19
United States v. *Grossman*, 843 F.2d 78 (2d Cir. 1988), cert. denied, 488 U.S. 1040 (1989) 24
United States v. *Marcus Schloss & Co.*, 710 F. Supp. 944 (S.D.N.Y. 1989) 23
United States v. *Newman*, 664 F.2d 12 (2d Cir. 1981), cert. denied, 464 U.S. 863 (1983) 14, 24
United States v. *ReBrook*, 58 F.3d 961 (4th Cir.), 116 S. Ct. 431 (1995) 21, 22

Statutes, regulations and rules:

Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq.*:
§ 10(b), 15 U.S.C. 78j(b) ..... *passim*
§ 14(e), 15 U.S.C. 78n(e) 2, 6, 8, 9, 10, 16, 17, 18, 19, 22
18 U.S.C. 1341 ..... 2, 9
18 U.S.C. 1956(a)(1)(B)(i) 2, 10
18 U.S.C. 1957 ..... 2, 10

Rules—Continued: Page

17 C.F.R.:
Section 240.10b-5 ..... 2, 6, 7, 10, 11, 12, 14, 16, 21
Section 240.14e-3 ..... 16, 17, 19, 20, 23
Section 240.14e-3(a) 2, 6, 8, 10, 17, 18

In the Supreme Court of the United States

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UNITED STATES OF AMERICA, PETITIONER

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

The Acting Solicitor General, on behalf of the United States, respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eighth Circuit in this case.

OPINION BELOW

The opinion of the court of appeals (App. 1a-39a)[1] is reported at 92 F.3d 612. The order of the district court denying the motion to dismiss the indictment (App. 73a-74a) and the report and recommendation of the magistrate judge (App. 40a-72a) are unreported.

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[1] "App." refers to the separately bound appendix to this petition.

JURISDICTION

The judgment of the court of appeals was entered on August 2, 1996. A petition for rehearing was denied on November 13, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES AND RULES INVOLVED

The texts of 18 U.S.C. 1341, 15 U.S.C. 78j(b) and 78n(e), and 17 C.F.R. 240.10b-5 and 240.14e-3(a) are reproduced at App. 76a-79a.

STATEMENT

Following a jury trial in the United States District Court for the District of Minnesota, respondent was convicted on 20 counts of mail fraud (Counts 1-20), in violation of 18 U.S.C. 1341; 17 counts of securities fraud (Counts 21-37), in violation of Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78j(b), and 17 C.F.R. 240.10b-5 (Rule 10b-5); 17 counts of fraudulent trading in connection with a tender offer (Counts 38-54), in violation of Section 14(e) of the Exchange Act, 15 U.S.C. 78n(e), and 17 C.F.R. 240.14e-3(a) (Rule 14e-3(a)); one count of engaging in a monetary transaction in property derived from an unlawful activity (Count 55), in violation of 18 U.S.C. 1957; and two counts of money laundering (Counts 56-57), in violation of 18 U.S.C. 1956(a)(1)(B)(i). Respondent was sentenced to 41 months' imprisonment, to be followed by three years of supervised release, and was fined $150,000. The court of appeals reversed all the convictions. App. 1a-39a.

1. Respondent was a partner in the law firm of Dorsey & Whitney, located in Minneapolis, Minnesota. App. 2a. In October 1986, a Dorsey & Whitney

client, Northrup King, transferred $1 million to the law firm's trust account in connection with the settlement of a lawsuit handled by respondent. IIa Tr. 67-74; VI Tr. 209-210. Although that money was supposed to remain in the trust account until disbursement was made to the plaintiffs, respondent withdrew the entire $1 million through transfers to his personal bank accounts. IIa Tr. 80-81; III Tr. 26-38; GX 1.

In July 1988, the trial court presiding over the lawsuit against Northrup King ordered respondent to distribute the funds held in the trust account under the settlement agreement. To replace the funds that he had stolen from the trust account, respondent used $185,000 that he had received from two other clients to settle other cases. By the end of August 1988, however, respondent still needed more than $400,000 to pay the remaining claims under the settlement. III Tr. 37-47, 217-219.

In July 1988, Dorsey & Whitney was retained as local counsel by Grand Metropolitan PLC (Grand Met), a company based in the United Kingdom, to represent it in connection with a possible tender offer for the common stock of Pillsbury Company, a company headquartered in Minnesota. IV Tr. 8-9; V Tr. 88-89; X Tr. 44-45; XI Tr. 20-21. On August 16, 1988, the board of directors of Grand Met approved the acquisition of all of Pillsbury's outstanding common stock. Grand Met originally planned to announce the tender offer to the public before or immediately after Labor Day, but the announcement was delayed several times. App. 2a; IV Tr. 8-17; V Tr. 88-89; X Tr. 42-45.

Thomas Tinkham was the Dorsey & Whitney partner assigned to head the team of attorneys

handling litigation matters in Grand Met's acquisition of Pillsbury. He was scheduled to meet with partners from the law firm's corporate department on August 26, 1988, to discuss whether the firm should continue to represent Grand Met in its attempt to acquire a local company. A few days before that meeting, respondent stopped by Tinkham's office. Respondent told Tinkham that he understood that Tinkham was working on the Pillsbury takeover, and expressed an interest in working on the case. Although Tinkham declined respondent's offer to work on the case, Tinkham discussed Grand Met's plans to acquire Pillsbury's common stock with respondent. IV Tr. 9-10; V Tr. 40-42, 89-99.

Grand Met and Dorsey & Whitney took extensive steps to maintain the confidentiality of information about the tender offer plans. Dorsey & Whitney limited the dissemination of information to as few people as possible within the firm; the firm's file on the matter was opened under the name of Cravath, Swaine & Moore (the New York law firm retained by Grand Met), and the subject of the representation was described under the heading "general matters." V Tr. 36-40. Even within Grand Met, only seven or eight people knew the proposed offering price for Pillsbury stock. X Tr. 30. Those efforts to keep the tender offer plans confidential were largely successful; Pillsbury stock maintained a steady price before the tender offer was announced, and investors discounted, as unfounded gossip, media stories suggesting a possible takeover of Pillsbury. III Tr. 97-104, 128-129; IV Tr. 25-27, 77, 96; VI Tr. 69-77, 105-106; XI Tr. 53-57.

Several weeks after Dorsey & Whitney began representing Grand Met, respondent began buying

call options for Pillsbury stock.[2] By August 25, 1988, respondent had accumulated a total of 500 Pillsbury call options (each option giving him a right to purchase 100 shares of Pillsbury stock), with an expiration date of September 17, 1988. Because the takeover was delayed beyond those options' expiration date, respondent did not exercise those options. App. 2a-3a & n.1; V Tr. 165, 181; VI Tr. 202-203; VIII Tr. 27-28; GX 34a.

After his discussion with Tinkham, respondent accumulated additional Pillsbury call options, with later expiration dates. On August 29, 1988, he began purchasing Pillsbury call options with an expiration date of October 22, 1988. The next day, he began purchasing Pillsbury call options with an expiration date of November 19, 1988. By the end of September 1988, respondent had amassed 2,500 Pillsbury call options. He financed those purchases with $200,000 in proceeds from a bank loan secured by a mortgage on his home. Respondent also purchased 5,000 shares of Pillsbury common stock on September 10, 1988, for just under $39 per share. App. 2a-3a & n.2; VI Tr. 198-200, 202-204; VIII Tr. 31-41; GX 34a, 37a.

On October 4, 1988, Grand Met publicly announced its tender offer for Pillsbury stock. Following the announcement, the price of Pillsbury stock rose from $39 per share to nearly $60 per share. Respondent then sold all his Pillsbury call options. See V Tr. 138-139, 180-181, 184-185; VIII Tr. 38-40, 42-43. He also sold all the Pillsbury stock that he had acquired. He made a total profit of more than $4.3 million on his

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[2] A call option gives the holder the right to purchase a specified number of shares of a stock, at a set "strike" price, on or before a certain expiration date. App. 2a n.1.

Pillsbury securities. App. 3a; VI Tr. 183-190; GX 47, 78.

Respondent used his profits from the Pillsbury trades to replenish the funds he had stolen from the firm's trust account. III Tr. 47-52; V Tr. 186-188. Confirmations of respondent's trades in Pillsbury securities were mailed to him by his brokerage firm. V Tr. 188-190.

2. Respondent argued, before trial and in the court of appeals, that the indictment did not state a violation of the securities laws. He contended, among other things, that Counts 21-37, which charged him with securities fraud under Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b), and Securities and Exchange Commission (SEC or Commission) Rule 10b-5, 17 C.F.R. 240.10b-5, should be dismissed because those counts alleged that he had breached only a fiduciary duty owed to Dorsey & Whitney and Grand Met, and not a duty owed to Pillsbury or its shareholders. He also contended that Counts 38-54, which charged him with fraudulent trading in connection with a tender offer under Section 14(e) of the Exchange Act, 15 U.S.C. 78n(e), and SEC Rule 14e-3(a), 17 C.F.R. 240.14e-3(a), should be dismissed because the Commission had exceeded its rulemaking authority in promulgating Rule 14e-3(a). The magistrate judge and the district court rejected those contentions. App. 54a-66a, 69a-70a, 73a-74a.

3. A divided panel of the court of appeals reversed respondent's convictions on all 57 counts. App. 1a-39a.

a. The court of appeals noted that respondent's convictions under Section 10(b) and Rule 10b-5 were based solely on the misappropriation theory of securities fraud. The misappropriation theory, the court explained, "has been held to impose § 10(b) and Rule

10b-5 liability for fraud on an individual who (1) misappropriates material nonpublic information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock." App. 9a (internal quotation marks omitted). Specifically, the court noted, respondent was alleged to have "breached a fiduciary duty to Dorsey & Whitney and Grand Met when, through his employment at Dorsey & Whitney, he obtained confidential, material, and nonpublic information concerning Grand Met's interest in acquiring Pillsbury, and subsequently used that information as a basis for trading in Pillsbury securities." *Id.* at 10a.

The court of appeals held that the misappropriation theory is not a valid basis for liability under Section 10(b) and Rule 10b-5, and it rejected contrary decisions of the Second, Seventh, and Ninth Circuits sustaining, and the Third Circuit discussing favorably, the misappropriation theory. App. 11a-24a. The court stated that the misappropriation theory does not require "deception," in that it "permits the imposition of § 10(b) liability based upon the mere breach of a fiduciary duty without a particularized showing of misrepresentation or nondisclosure," *id.* at 12a-13a, and "the mere breach of a fiduciary obligation, without misrepresentation or nondisclosure, is not deception within the meaning of § 10(b)," *id.* at 13a.

The court also concluded that the misappropriation theory conflicts with Section 10(b)'s requirement that the fraud be employed "in connection with the purchase or sale of any security." According to the court, the misappropriation theory "permits liability for a breach of a duty owed to individuals who are

unconnected to and perhaps uninterested in a securities transaction, thus rendering meaningless the 'in connection with . . .' statutory language." App. 13a. Since, the court noted, "the principal concern of section 10(b) is the protection of purchasers and sellers of securities," it concluded that "only a breach of a duty to parties to the securities transaction, or, at the most, to other market participants such as investors, will be sufficient to give rise to § 10(b) liability." *Id.* at 13a-14a.

b. The court of appeals also reversed respondent's convictions for improper trading in connection with a tender offer, under Section 14(e) and Rule 14e-3(a). It held that the SEC exceeded its rulemaking authority under Section 14(e) when it promulgated Rule 14e-3(a), which prohibits specified persons from trading while in possession of material, confidential information relating to a tender offer, unless that information is first publicly disclosed to the market. App. 24a-36a. It rejected decisions of the Second, Seventh, and Tenth Circuits upholding Rule 14e-3(a). See App. 26a-27a.

The court observed that Section 14(e) empowers the SEC to "define" and "prescribe means reasonably designed to prevent" "acts and practices" which are "fraudulent." App. 28a. It held, however, that, notwithstanding the statute's grant of authority to the SEC to "define" acts that are fraudulent, Section 14(e) does not authorize the SEC to define, as a "fraudulent" act or practice, the nondisclosure of information, without the requirement of a breach of a fiduciary duty. The court concluded that "the enabling provision of § 14(e) permits the SEC to identify and regulate those 'acts and practices' which fall within the § 14(e) legal definition of 'fraudulent,' but it

does not grant the SEC a license to redefine the term." App. 28a-29a. The court also concluded that the SEC's additional authority under the statute "to prescribe means reasonably designed to prevent" fraudulent acts was of no significance; "this provision means simply that the SEC has broad regulatory powers in the field of tender offers, but the statutory terms have a fixed meaning which the SEC cannot alter by way of an administrative rule." *Id.* at 35a.

As to the meaning of "fraudulent" in Section 14(e), the court found "no indication that the term was to have a meaning different from its common legal definition." App. 29a. The court concluded "that 'fraudulent' under § 14(e) must be interpreted to require the breach of a fiduciary obligation or similar trust relationship." *Id.* at 32a. The court thus held that "the SEC exceeded its rulemaking authority under § 14(e) when it promulgated Rule 14e-3(a) without including a requirement of a breach of a fiduciary obligation." *Id.* at 36a.

c. Based on its reversal of the securities fraud convictions, the court of appeals also reversed respondent's mail fraud convictions under 18 U.S.C. 1341. App. 36a-37a. It noted that "[t]he mere fact that [respondent's] securities convictions have been reversed does not as a matter of law require that the mail fraud convictions likewise be reversed." *Id.* at 36a. In the court's view, however, "the indictment was structured in such a manner as to premise the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud." *Id.* at 37a. "Because [respondent's] conduct did not constitute securities

fraud," the court reasoned that "there was no fraud upon which to base the mail fraud charges." *Ibid.*[3]

d. Judge Fagg dissented. App. 38a-39a. He pointed out that four circuits had upheld the misappropriation theory of securities fraud under Section 10(b) of the Exchange Act and Rule 10b-5. App. 38a. He also noted that the three circuits had held that the SEC did not exceed its rulemaking authority under Section 14(e) of the Exchange Act when it promulgated Rule 14e-3(a) without the requirement of a breach of a fiduciary duty. App. 38a. Adopting the views of those other circuits, Judge Fagg would have affirmed respondent's convictions on all 57 counts. *Id.* at 38a-39a.

REASONS FOR GRANTING THE PETITION

The court of appeals has rendered three major holdings that critically weaken the government's ability to prosecute the misuse of material, nonpublic information in the securities markets. First, the court held that the misappropriation theory of insider trading is an impermissible basis for imposing liability under Section 10(b) of the Exchange Act and Rule 10b-5. Second, the court held that the SEC exceeded its rulemaking authority under Section 14(e) of the Exchange Act in promulgating Rule 14e-3, a rule designed to prevent improper use of nonpublic information in the tender offer context. Third, the court of appeals held that respondent's scheme to misuse

[3] The court also overturned respondent's conviction for engaging in a monetary transaction in property derived from an unlawful activity under 18 U.S.C. 1957, and his convictions for money laundering under 18 U.S.C. 1956(a)(1)(B)(i), because "they were predicated on the securities fraud or mail fraud counts." App. 37a.

nonpublic information in breach of his fiduciary duties for the purpose of trading in securities did not violate the mail fraud statute. Each of those holdings is incorrect. Each conflicts with the decisions of other courts of appeals, and the holding on the mail fraud counts conflicts with a decision of this Court. Each holding also deprives the government of an important tool with which to combat the fraudulent misappropriation and misuse of information in securities trading. This Court's review is therefore warranted.

1. a. Section 10(b) of the Exchange Act prohibits the use, "in connection with the purchase or sale of any security," of "any manipulative or deceptive device or contrivance" in violation of rules promulgated by the Commission. 15 U.S.C. 78j(b). Rule 10b-5 prohibits "*any* person" from engaging in "*any* act [or] practice" that "operates or would operate as a fraud or deceit upon *any* person" in connection with the purchase or sale of securities. 17 C.F.R. 240.10b-5 (emphasis added).

Under the so-called "classical" theory of insider trading liability, it is a violation of Section 10(b) and Rule 10b-5 for a person who owes a fiduciary or similar duty of trust and confidence to the shareholders of a corporation to trade in the securities of that corporation with material, nonpublic information of the corporation. See *Dirks* v. *SEC*, 463 U.S. 646, 653-654 (1983); *Chiarella* v. *United States*, 445 U.S. 222 (1980). The classical theory, however, does not reach persons who trade on misappropriated information in the securities of companies to which they do *not* owe such a duty. That situation commonly arises when (as in this case) someone misappropriates information about a planned takeover of a target company by another

company to which he owes a fiduciary duty, and then trades in the securities of the target company. In the absence of a fiduciary or similar duty of trust and confidence to the target company's shareholders, the person's trading is not a fraud on the shareholders with whom the person trades. See *Chiarella*, 445 U.S. at 232-235 (financial printer who misappropriated information about upcoming takeovers and traded in the target companies' stock not liable for fraud on those investors).

Nonetheless, in such a situation, the misuse of the confidential information does harm the entity to which that person owes a fiduciary duty (such as the company planning the takeover or the law firm acting for it). The misuse of the information interferes with the right of the company or law firm to control its use. Moreover, the trading on the misappropriated information can drive up the price of the shares of the target company, making it more expensive for the bidding company to acquire those shares. The misappropriation theory fills the gap in protection left by the "classical" theory. It provides that a person who misappropriates material, nonpublic information, in breach of a fiduciary or similar duty of trust and confidence, and trades in the security on that information, violates Section 10(b) and Rule 10b-5. See, *e.g.*, *SEC* v. *Cherif*, 933 F.2d 403 (7th Cir. 1991), cert. denied, 502 U.S. 1071 (1992).

b. The court of appeals gave two reasons for rejecting the misappropriation theory, each of which is erroneous. First, the court of appeals suggested that the misappropriation theory is invalid because it does not require "deception," as the language of Section 10(b) demands, but rests instead only on a breach of fiduciary duty. App. 11a-13a. That is incorrect.

A person who misappropriates information in breach of a fiduciary duty necessarily commits deception. The fiduciary, while maintaining a pretense of loyalty, in fact uses his privileged position of trust and confidence to exploit the principal's confidential information for personal gain. The law has long recognized that this form of misconduct is a "deceptive practice" that constitutes fraud. See *Carpenter* v. *United States*, 484 U.S. 19, 27-28 (1987) (holding that such misappropriation of information by a fiduciary violates the mail fraud statute).

Second, the court of appeals concluded that any fraud in a misappropriation case is not "in connection with the purchase or sale of securities," as required by Section 10(b). App. 13-17a. The fraud in a misappropriation case, however, is directly linked to the *misappropriator's* purchase or sale of securities; indeed, the information has value to that person only because it permits him "to reap instant no-risk profits in the stock market." *SEC* v. *Materia*, 745 F.2d 197, 203 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985). A violation is established under the misappropriation theory only if the misappropriator (or his tippee) trades in securities. The trading on the misappropriated information establishes that the fraud is committed "in connection with" the purchase or sale of securities.

The court of appeals suggested, however, that Section 10(b) is intended principally to protect the purchasers and sellers of securities, and that the misappropriation theory therefore improperly extends Section 10(b) beyond the protection of market participants. App. 15a-16a. The proscription against fraud in Section 10(b), however, is not textually limited to fraud on market participants; there is no textual basis

for excluding from the statute's scope fraud practiced on the source of confidential information used for securities trading. And in any event, this case does not present the difficulty perceived by the court of appeals, for the facts of this case involve misappropriation of information about an upcoming takeover from the bidder and a law firm retained to represent it. The proper functioning of the securities markets requires that the bidder, who is indeed poised to be a "market participant," be protected against the fraudulent use of its confidential business plans. The same protection against fraud is needed for the law firms and investment advisers who represent and counsel bidders in upcoming transactions, who are privy to their confidential information because they are assisting bidders in their planned participation in the securities markets, and who are necessary to that market participation, especially in tender offers.

c. The court of appeals' holding deepens a conflict in the circuits over the validity of the misappropriation theory. Until 1995, that theory had been upheld by all of the courts of appeals that had considered it. The Second Circuit was the first to embrace the theory. In *United States* v. *Newman*, 664 F.2d 12, 17 (1981), cert. denied, 464 U.S. 863 (1983), employees of investment bankers who had been retained by bidders conspired to trade in the securities of the bidder's takeover targets. The court of appeals upheld convictions under Section 10(b) and Rule 10b-5, explaining that the "deceitful misappropriation of confidential information by a fiduciary" constituted fraud in connection with the purchase of shares in the target companies. 664 F.2d at 17. In *SEC* v. *Materia*, a case in which a financial printer had misappropriated confidential information from his employer about

upcoming tender offer targets, the court upheld liability under Section 10(b) and Rule 10b-5, stating that "one who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage violates Section 10(b) and Rule 10b-5." 745 F.2d at 203. The theory has since been upheld in *SEC* v. *Cherif*, 933 F.2d at 410 ("[A] person violates Rule 10b-5 and Section 10(b) * * * by misappropriating and trading upon material information entrusted to him by virtue of a fiduciary relationship such as employment."), and *SEC* v. *Clark*, 915 F.2d 439, 453 (9th Cir. 1990) ("[A]n employee's knowing misappropriation and use of his employer's material nonpublic information regarding its intention to acquire another firm constitutes a violation of § 10(b) and Rule 10b-5."); see also *Rothberg* v. *Rosenbloom*, 771 F.2d 818, 822 (3d Cir. 1985) ("An insider on either side of a proposed transaction violates the insider trading rule when he uses insider information in violation of the fiduciary duty owed to the corporation to which he owes a duty of confidentiality."), cert. denied, 481 U.S. 1017 (1987).

In *United States* v. *Bryan*, 58 F.3d 933 (1995), the Fourth Circuit broke with that line of authority. The Fourth Circuit rejected the misappropriation theory because (it believed) that theory requires only a breach of fiduciary duty, not deception, and it covers alleged frauds that are not "in connection with" the purchase or sale of securities, at least where the victim is not an actual or prospective market participant. *Id.* at 949-952. The Eighth Circuit in this case explicitly followed *Bryan*'s analysis. App. 18a. The Eighth Circuit also acknowledged the circuit conflict, noting that "we respectfully decline to follow the

holdings of sister circuits which have adopted the misappropriation theory." *Id.* at 22a.

In *Chiarella*, although the government relied on the misappropriation theory, this Court did not reach the issue because the jury had not been instructed on that theory of liability. 445 U.S. at 235-236. Four members of the Court, however, expressed support for the theory. See *id.* at 239 (Brennan, J., concurring); *id.* at 245 (Burger, C.J., dissenting) (Chiarella "misappropriated—stole to put it bluntly—valuable nonpublic information" and then "exploited his ill-gotten informational advantage by purchasing securities in the market"); *id.* at 245 (Blackmun & Marshall, JJ., dissenting). In *Carpenter*, the Court was equally divided on the validity of the misappropriation theory as applied to a reporter's fraudulent use of confidential information owned by his newspaper about upcoming columns for the purpose of trading in the securities of companies to be discussed in the columns. 484 U.S. at 24.

The misappropriation question is important to the proper construction of Section 10(b) and Rule 10b-5, the courts of appeals are divided on the question, and the issue is squarely presented in this case. This Court's resolution of the issue is therefore warranted.

2. The court of appeals also erroneously invalidated Rule 14e-3, promulgated by the SEC under its rulemaking authority in Section 14(e) of the Act. That holding conflicts with decisions of three other courts of appeals.

a. Section 14(e) makes it unlawful for any person, *inter alia*, "to engage in any fraudulent, deceptive, or manipulative acts or practices" in connection with a tender offer. 15 U.S.C. 78n(e). Through two separate

grants of rulemaking authority, Section 14(e) empowers the Commission to (a) "define * * * such acts and practices as are fraudulent, deceptive or manipulative" and (b) "prescribe means reasonably designed to prevent[] such acts and practices." The Commission promulgated Rule 14e-3 under its Section 14(e) rulemaking authority. Rule 14e-3(a) prohibits the purchase or sale of a security after a substantial step has been taken to commence a tender offer when the purchaser or seller knows that he is in possession of material, nonpublic information relating to the tender offer acquired directly or indirectly from the offeror, the issuer, or anyone acting on behalf of either.

Rule 14e-3 responds to the fact that tender offers present significant opportunities for insider trading abuse because "even a hint of an upcoming tender offer may send the price of the target company's stock soaring." *Materia*, 745 F.2d at 199. The prospect of virtually risk-free profits may tempt persons with access to material, nonpublic information to trade before that information becomes public. To protect against the improper exploitation of such information, Rule 14e-3(a) proscribes trading while in possession of material, nonpublic information in the tender offer context, without requiring a showing that the trading breaches a fiduciary duty. While trading on such information most often will involve a breach of a duty of confidentiality to the bidder or target company, or to persons representing either party, the difficulties of establishing such a breach may permit sophisticated insider trading to go unredressed. Rule 14e-3(a) avoids that problem by flatly proscribing a class of securities transactions in which the likelihood that such a breach of duty has occurred is great. The

SEC's promulgation of this "legislative regulation[]" is entitled to "controlling weight," unless the rule is "arbitrary, capricious, or manifestly contrary to the statute." *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843-844 (1984).

The court of appeals found neither of the two grants of rulemaking authority in Section 14(e) sufficient to sustain Rule 14e-3(a). App. 28a-36a. First, the court believed that the SEC is not empowered by Section 14(e) to define as a "fraudulent" act or practice a course of conduct that does not already fit within the independent proscription of "fraudulent" or "deceptive" acts or practices in the first sentence of Section 14(e). But Section 14(e)'s delegation of rulemaking authority to the SEC to "define" fraudulent acts or practices would be a virtual nullity if the SEC were limited to duplicating the coverage of Section 14(e)'s independent proscriptions. Instead, as this Court has recognized, the SEC's definitional authority affords "a mechanism for defining * * * those acts and practices which involve material misrepresentation or nondisclosure" in the tender offer context. *Schreiber* v. *Burlington Northern, Inc.*, 472 U.S. 1, 11 n.11 (1985). Contrary to the court of appeals' reasoning, the Commission was well within its authority to define a specific act or practice as fraudulent in the tender offer setting without requiring "the breach of a fiduciary obligation or similar trust relationship." App. 32a.

Second, the court of appeals also concluded that Rule 14e-3(a) could not be sustained as a "means reasonably designed to prevent" fraudulent acts or practices, because (it believed) the Commission's powers are limited to regulating fraud as defined in the statute. App. 33a-34a. This Court has noted, however,

that Section 14(e) gives the Commission "latitude to regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts." *Schreiber*, 472 U.S. at 11 n.11. By establishing a bright-line rule proscribing the exploitation of nonpublic information about tender offers, Rule 14e-3 serves to prevent fraudulent misuses of that information.

b. Until the decision in this case, all of the courts of appeals that had addressed the issue had found Rule 14e-3 to be valid. In *United States* v. *Chestman*, 947 F.2d 551 (1991) (en banc), cert. denied, 503 U.S. 1004 (1992), the Second Circuit, in upholding Rule 14e-3, concluded that the SEC's rulemaking authority to define fraudulent practices could not be cabined by "common law" concepts of fraud without rendering the statute's rulemaking grant "superfluous." 947 F.2d at 558. The court of appeals also found Rule 14e-3 valid as a means "reasonably designed to prevent fraud" because that grant of rulemaking authority necessarily "encompasses the power to proscribe conduct outside the purview of fraud, be it common law or SEC-defined fraud." *Ibid.* (internal quotation marks ommitted). The Tenth and the Seventh Circuits have similarly upheld Rule 14e-3. See *SEC* v. *Maio*, 51 F.3d 623, 635 (7th Cir. 1995) ("Rule 14e-3 is clearly within the SEC's statutory grant of authority to 'prescribe means reasonably designed to prevent . . . such acts and practices as are fraudulent, deceptive, or manipulative.'"); *SEC* v. *Peters*, 978 F.2d 1162, 1167 (10th Cir. 1992) ("In order effectively to prevent people from fraudulently trading on insider information obtained or used in breach of a fiduciary duty, the SEC may appropriately promulgate the fairly broad proscriptions in Rule 14e as a

prophylactic measure. * * * [I]n the tender offer context, Rule 14e-3 is consistent with the SEC's explicit and broad rulemaking authority under Section 14(e).").

The court of appeals in this case acknowledged that, in invalidating Rule 14e-3, it "must depart from the holdings of our sister circuits." App. 27a. This Court's review is warranted to resolve the conflict among the courts of appeals on this important issue of securities law.

3. The court of appeals erred further in reversing respondent's mail fraud convictions. The court acknowledged that, under this Court's decision in *Carpenter* v. *United States*, 484 U.S. 19 (1987), "[t]he mere fact that [respondent's] securities convictions have been reversed does not as a matter of law require that the mail fraud convictions likewise be reversed." App. 36a. It nonetheless concluded that the mail fraud convictions could not stand because (it believed) "the indictment was structured in such a manner as to premise the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud." *Id.* at 37a. "Because [respondent's] conduct did not constitute securities fraud," the court reasoned, "there was no fraud upon which to base the mail fraud charges." *Ibid.* The court of appeals' reversal of the mail fraud convictions cannot be reconciled with *Carpenter*. The decision also reflects a misunderstanding of the way in which mail fraud cases (including this case) are prosecuted.

In *Carpenter*, a *Wall Street Journal* reporter who traded stock in anticipation of the publication of his *Journal* column, which often had an effect on the market price of stocks discussed in it, was convicted of securities fraud as well as mail and wire fraud. The

Court noted that the same "appropriation of confidential information [owned by the *Journal*] * * * underlay both the securities laws and mail and wire fraud counts." 484 U.S. at 24. Although the Court was evenly divided with respect to the convictions under the securities laws, it unanimously affirmed the mail and wire fraud convictions. *Ibid.* The Court ruled that an employee's misappropriation of confidential business information from his employer, in breach of his fiduciary obligation to that employer, falls within the scope of the mail fraud statute. *Id.* at 25-28.

Carpenter establishes that a person who misappropriates confidential business information in breach of a fiduciary duty and then trades on it in the stock market has engaged in a scheme to defraud within the mail fraud statute, whether or not the identical conduct violates the securities laws. Contrary to the court of appeals' decision in this case, therefore, a defendant may be punished for mail fraud even if the indictment "premise[s] the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud." See App. 37a; pp. 9-10, *supra*. The Fourth Circuit, following *Carpenter*, has recognized that point in two related cases in which it upheld the defendants' mail fraud convictions even while reversing their securities fraud convictions, based on the same acts, in light of its rejection of the misappropriation theory of liability under Section 10(b) and Rule 10b-5. See *United States* v. *Bryan*, 58 F.3d at 943, 945; *United States* v. *ReBrook*, 58 F.3d 961, 966-967 (4th Cir.), cert. denied, 116 S. Ct. 431 (1995).

The court of appeals suggested that, because respondent's conduct did not constitute securities fraud, "there was no fraud upon which to base the mail

fraud charges." App. 37a. The court may have believed that respondent was charged with committing mail fraud by using the mails to commit violations of Section 10(b) and 14(e). That is not how the indictment was framed, however, and the mail fraud counts were not dependent on the securities fraud counts. Nor, in indictments charging both mail fraud and securities fraud violations, are the mail fraud counts made dependent on the securities fraud charges in such a manner. The mail fraud statute "reach[es] any scheme to deprive another of money or property by means of false of fraudulent pretenses, representatives, or promises," *Carpenter*, 484 U.S. at 27, and the elements of that offense are "(1) a scheme to defraud, and (2) the mailing of a letter, etc., for the purpose of executing the scheme," *Pereira* v. *United States*, 347 U.S. 1, 8 (1954). The scheme to defraud need not also be shown to be illegal under a separate provision of law, such as Section 10(b). "[T]he two crimes are distinct and require the government to prove different elements in order to secure a conviction." *ReBrook*, 58 F.3d at 967.

While, in this case, the conduct that constituted the charged scheme to defraud was essentially the same for purposes of both the securities and mail fraud counts, the mail fraud counts did not charge, as an element, that respondent had violated the securities laws. Further, the trial court instructed the jury on the mail fraud counts separately and independently of the securities fraud counts, and gave the jury no indication that proof of a mail fraud violation was dependent on proof of a securities law violation. See XII Tr. 21-24. Accordingly, respondent's conviction on the mail fraud count was not dependent on a finding that he violated the securities laws, and whether or

not his misappropriation of confidential information about Grand Met's takeover plans violated the securities laws, his misappropriation of that confidential information in breach of his fiduciary duties to Grand Met and his law firm amounted to mail fraud.

4. The court of appeals' rulings in this case have significant ramifications for the government's ability to prosecute insider trading crimes and for the Commission's ability to enforce the federal securities laws. The misappropriation theory has been a central tool in combatting insider trading involving the misappropriation of confidential information. By freeing that form of misconduct from federal regulation, the court of appeals' decision has opened a large loophole in the protections against fraud afforded by federal law.

The misappropriation theory under Section 10(b) and the prohibitions contained in Rule 14e-3 have been successfully deployed against the misuse of inside information in a wide variety of cases. See, *e.g.*, *SEC* v. *Materia*, Fed. Sec. L. Rep. (CCH) ¶ 99,526 (S.D.N.Y. 1983), aff'd, 745 F.2d 197 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985); *United States* v. *Marcus Schloss & Co.*, 710 F. Supp. 944 (S.D.N.Y. 1989); *SEC* v. *Vaskevitch*, 657 F. Supp. 312 (S.D.N.Y. 1987); *SEC* v. *Musella*, 578 F. Supp. 425 (S.D.N.Y. 1984); *SEC* v. *Tome*, 638 F. Supp. 596 (S.D.N.Y. 1986), aff'd, 833 F.2d 1086 (2d Cir. 1987), cert. denied, 486 U.S. 1014 (1988); *SEC* v. *Boesky*, Fed. Sec. L. Rep. (CCH) ¶ 92,991 (S.D.N.Y. 1986) (consent judgment); *SEC* v. *Levine*, No. 86 Civ. 3726 (S.D.N.Y. 1986) (consent judgment); *SEC* v. *Drexel Burnham Lambert*, Fed. Sec. L. Rep. (CCH) ¶ 94,474 (S.D.N.Y. 1990) (consent judgment); *SEC* v. *Milken*, Fed. Sec. L. Rep. (CCH) ¶ 95,200

(S.D.N.Y. 1990) (consent judgment). The mail fraud statute has likewise been used effectively to prosecute fraudulent conduct involving the misuse of confidential information in securities trading by a variety of persons with access to such information. See, *e.g.*, *Carpenter* v. *United States*, *supra* (journalist); *United States* v. *Newman*, *supra* (tippee of investment bankers); *United States* v. *Grossman*, 843 F.2d 78, 85-86 (2d Cir. 1988) (attorney), cert. denied, 488 U.S. 1040 (1989).

By casting a cloud on the validity of those important theories of liability, the court of appeals' decision impairs the government's ability to ensure the maintenance of honest securities markets. Investor confidence in the honesty of this Nation's securities markets can only be undermined by the knowledge that trading in securities on misappropriated information is beyond the reach of federal law. That concern is heightened when the deceptive breach of fiduciary duty is that of an attorney, whose professional obligation to protect his client's confidences is essential. The circuit conflicts raised by the decision in this case thus warrant this Court's review.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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In the Supreme Court of the United States

OCTOBER TERM, 1996

UNITED STATES OF AMERICA, PETITIONER

v.

JAMES HERMAN O'HAGAN

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI

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TABLE OF CONTENTS

	Page
Appendix A (court of appeals' opinion dated Aug. 2, 1996)	1a
Appendix B (magistrate's opinion dated Sept. 10, 1993)	40a
Appendix C (district court opinion dated Dec. 30, 1993)	73a
Appendix D (court of appeals' order dated Nov. 13, 1996)	75a
Appendix E (statutory and regulatory provisions)	76a

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

Nos. 94-3714, 94-3856

UNITED STATES OF AMERICA,
PLAINTIFF-APPELLEE/CROSS-APPELLANT

v.

JAMES HERMAN O'HAGAN,
DEFENDANT-APPELLANT/CROSS-APPELLEE

Submitted: October 17, 1995
Decided: Aug. 2, 1996

Before: FAGG, LAY, and HANSEN, Circuit Judges.

HANSEN, Circuit Judge.

James Herman O'Hagan appeals his convictions of all counts in a 57-count indictment for mail fraud, securities fraud, and money laundering. The government cross-appeals, contending that the district court erroneously calculated O'Hagan's sentence. Although O'Hagan raises a whole host of issues, we find merit in two particular claims. First, neither the statutory language of section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), nor Supreme Court precedent interpreting it, will support the use of the "misappropriation theory," the theory which formed the basis for O'Hagan's § 10(b) securities fraud convictions. Second, the Securities and Exchange Commission (SEC) exceeded its rulemaking

authority under section 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(e), when it promulgated Rule 14e-3(a), 17 C.F.R. § 240.14e-3(a), and omitted therefrom the requirement that a breach of a fiduciary duty must be shown in order to violate the rule. The mail fraud counts are structured in the indictment to hinge on the validity of the securities fraud counts, and the money laundering counts in turn are dependent upon the mail fraud or securities fraud counts. Accordingly, we vacate all of O'Hagan's convictions. The government's cross-appeal is dismissed as moot.

I.

James Herman O'Hagan was a partner in the Dorsey & Whitney law firm in Minneapolis, Minnesota. In approximately July of 1988, Grand Met PLC (Grand Met), a large diversified company based in London, England, retained Dorsey & Whitney as local counsel because Grand Met was interested in acquiring the Pillsbury Company (Pillsbury), a Minneapolis, Minnesota, company. Throughout the remainder of the summer and into the fall of 1988, Grand Met maintained a continued interest in acquiring Pillsbury, but before moving forward with an actual tender offer, it first had to sell a subsidiary company in order to have sufficient capital to finance the purchase of Pillsbury.

On August 18, 1988, O'Hagan began purchasing call options for Pillsbury stock that had a September 17, 1988, expiration date.[1] He subsequently purchased

[1] A call option gives the holder the right to purchase a specified number of shares of stock by a certain date at a specific price. If the shares are not purchased by that date, the option expires and along with it the right to purchase the specified number of shares. For instance, on August 18, 1988, O'Hagan purchased 100 Pillsbury call options. Each call option gave him the right to purchase 100 shares of Pillsbury stock. Each call option also expired on September 17, 1988, if the option was not exercised.

call options that had October 22, 1988, and November 19, 1988, expiration dates. By the end of September 1988, O'Hagan had amassed 2,500 Pillsbury call option contracts.[2] He also held approximately 5000 shares of Pillsbury common stock which he had purchased on September 10, 1988.

On October 4, 1988, Grand Met publicly announced its tender offer for Pillsbury stock. Pillsbury stock immediately rose from $39 per share to almost $60 per share.[3] Shortly thereafter, O'Hagan exercised his options, purchasing the Pillsbury stock at the lower option price, and then liquidating the stock, along with the previously purchased 5000 shares of common stock, for the higher market price generated by the tender offer. He realized a profit of over $4,000,000 from these securities transactions.

The Securities and Exchange Commission (SEC) subsequently commenced an investigation of O'Hagan and others who had heavily invested in Pillsbury securities shortly before its takeover by Grand Met. This investigation, which was later joined by other

[2] O'Hagan purchased 3,000 Pillsbury call option contracts during August and September 1988. At the end of September of 1988, he held only 2,500 of those contracts because 500 contracts had a September 17, 1988, expiration date.

[3] "When a tender offer is announced, usually the price of the target company rises and the price of the offeror falls or remains the same." *SEC v. Maio*, 51 F.3d 623, 628 n.3 (7th Cir. 1995).

federal law enforcement authorities, culminated with O'Hagan being charged in the instant 57-count indictment. Counts 1-20 charged him with mail fraud in violation of 18 U.S.C. § 1341. Counts 21-37 charged him with securities fraud in violation of § 10(b) and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder. Counts 38-54 charged O'Hagan with securities fraud in violation of § 14(e) and Rule 14e-3, 17 C.F.R. § 240.14e-3(a), promulgated thereunder. Counts 55-57 alleged various violations of the federal money laundering statutes, 18 U.S.C. §§ 1956(a)(1)(B)(i) and 1957.

The case proceeded to trial, and a jury convicted O'Hagan on all 57 counts. The district court sentenced O'Hagan to 41 months of imprisonment. O'Hagan appeals.

II.

Because we resolve the issues in this case solely on legal grounds, our standard of review is de novo. *United States v. Hang*, 75 F.3d 1275, 1279 (8th Cir. 1996).

A.

O'Hagan challenges his § 10(b) securities fraud convictions, arguing that the theory of liability under which the government prosecuted him, known as the "misappropriation theory," is, as a matter of law, an impermissible basis upon which to impose § 10(b) liability. Before outlining the misappropriation theory, however, we first turn to the language of § 10(b) and its SEC-created counterpart, Rule 10b-5.

Section 10(b) of the Securities Exchange Act of 1934 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b). The touchstones of § 10(b) liability then, are "manipulation" and "deception" "in connection with the purchase or sale of any security." *Id.* Our focus in this case is on the deception element of § 10(b).[4]

---

[4] The other prong of § 10(b) liability, "manipulation" is " 'virtually a term of art when used in connection with securities markets' " referring to practices "such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." *Santa Fe Indus. v. Green*, 430 U.S. 462, 476 (1977) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976)). The government does not contend, and the record does not show, that O'Hagan's conduct constituted any of these prohibited acts. In any event, the misappropriation theory thus far has been used only as a vehicle to prosecute acts that constitute deception under § 10(b) and that was the government's approach in this case.

Acting pursuant to the authority granted to it under § 10(b), the SEC promulgated Rule 10b-5, which provides in relevant part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) [t]o employ any device, scheme, or artifice to defraud, [or]
>
> . . .
>
> (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5. The SEC thus enacted Rule 10b-5 to include a prohibition on "fraud" as a means of defining the scope of conduct proscribed by the term deception under § 10(b). Significantly, however, fraud under Rule 10b-5 cannot be construed more broadly than its statutory enabler, deception; in other words, Rule 10b-5 fraud cannot prohibit conduct that does not amount to § 10(b) deception. *See Central Bank of Denver v. First Interstate Bank of Denver*, 114 S. Ct. 1439, 1446 (1994) ("We have refused to allow 10b-5 challenges to conduct not prohibited by the text of the statute."); *Santa Fe Indus. v. Green*, 430 U.S. 462, 472 (1977) ("in deciding whether [challenged conduct constitutes] 'fraud' under Rule 10b-5, 'we turn first to the language of § 10(b),'") (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976)). Thus, although § 10(b) has been described as a broad catchall provision, the fraud that must be caught must also constitute deception within the meaning of the statute. *United States v. Chiarella* 445 U.S. 222, 234-35 (1980) ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.").

In construing the scope of conduct that may be regulated under § 10(b), the Supreme Court has definitively ruled that the text of the statute is dispositive. *See Central Bank*, 114 S. Ct. at 1446 ("With respect . . . to . . . the scope of conduct prohibited by § 10(b), the text of the statute controls our decision."); *see also Chiarella*, 445 U.S. at 234 ("As we have emphasized before, the 1934 Act cannot be read '"more broadly than its language and the statutory scheme reasonably permit."'" (citation omitted)). This point could not have been made in clearer terms than in *Central Bank*, the Court's most recent exposition of the reach of § 10(b). There, concluding that a § 10(b) aiding and abetting cause of action was not viable, the Court stated:

> We reach the uncontroversial conclusion, accepted even by those courts recognizing a § 10(b) aiding and abetting cause of action, that the text of the 1934 Act does not itself reach those who aid and abet a § 10(b) violation. Unlike those courts, however, we think that conclusion resolves the case. It is inconsistent with settled methodology in § 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text.
>
> . . .
>
> Because this case concerns the conduct prohibited by § 10(b), the statute itself resolves the case. . . .

Central Bank, 114 S. Ct. at 1448. This is because "[t]he language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception." *Santa Fe*, 430 U.S. at 473. In sum, in determining whether conduct falls within § 10(b) deception and Rule 10b-5 fraud, we are confined to what the term deception under § 10(b) will reasonably bear. *See United States v. Bryan*, 58 F.3d 933, 945 (4th Cir. 1995) ("For at least two decades, however, the Supreme Court has repeatedly warned against expanding the concept of fraud in the securities context beyond what the words of the Act will reasonably bear."). It is against this backdrop that we now turn to the two theories of liability which have been created under § 10(b)'s proscription of deception.

The first theory is what has been termed the "classical theory." *See SEC v. Clark*, 915 F.2d 439, 443 (9th Cir. 1990). It was outlined by the Supreme Court in the germinal case of *Chiarella*, 445 U.S. at 226-35, and later refined in *Dirks v. SEC*, 463 U.S. 646, 653-667 (1983). "Under the classical theory, a person violates [Rule 10b-5] when he or she buys or sells securities on the basis of material, non-public information and at the same time is an insider of the corporation whose securities are traded." *SEC v. Cherif*, 933 F.2d 403, 408 (7th Cir. 1991), *cert. denied*, 502 U.S. 1071 (1992). The gravamen of the classical theory is that the "insider owes a fiduciary duty to the corporation's shareholders not to trade on inside information for his personal benefit." *Id.* at 409. In sum, the classical theory deals with corporate "insiders," *i.e.*, those who owe a fiduciary obligation to the shareholders of the corporation whose shares are traded. This theory, however, does not reach those

individuals who trade securities based on material, nonpublic information and who owe no fiduciary duty to the shareholders of the company whose securities are traded; these persons are the so-called "outsiders." *See Clark*, 915 F.2d at 443.

The misappropriation theory addresses those not within the reach of the classical theory. Specifically, it:

> extends the reach of Rule 10b-5 to outsiders who would not ordinarily be deemed fiduciaries of the corporate entities in whose stock they trade. [It] focuses not on the insider's fiduciary duty to the issuing company or its shareholders but on whether the insider breached a fiduciary duty to any lawful possessor of material non-public information.

Cherif, 933 F.2d at 409. The misappropriation theory has been held to impose § 10(b) and Rule 10b-5 liability for fraud on an individual who "'(1) misappropriates material nonpublic information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock.'" *Bryan*, 58 F.3d at 944 (quoting *Clark*, 915 F.2d at 443). Under the misappropriation theory, the requirement that the information be used "in connection with the purchase and sale of any security" is satisfied simply because the misappropriated information is used in a subsequent securities transaction. *See id.* at 944-45. The misappropriation theory thus focuses on whether the securities trader breached a fiduciary obligation to the party from whom the material nonpublic information was obtained, notwithstanding whether that

party had any connection to, or even an interest in, the securities transaction, and also without concern as to whether a party who did care about the securities transaction was defrauded. *Id.*

In this case, the government proceeded against O'Hagan on the § 10(b) and Rule 10b-5 counts under the misappropriation theory, although the theory has never been recognized in this circuit. The government contended that O'Hagan breached a fiduciary duty to Dorsey & Whitney and Grand Met when, through his employment at Dorsey & Whitney, he obtained confidential, material, and nonpublic information concerning Grand Met's interest in acquiring Pillsbury, and subsequently used that information as a basis for trading in Pillsbury securities.[5] O'Hagan contends that the misappropriation theory is an impermissible basis upon which to impose § 10(b) liability. Specifically, he argues that the theory cannot be squared with either the plain text of § 10(b) or the

[5] The government did not prosecute O'Hagan under the classical theory, nor could it, because O'Hagan was not an "insider" of Pillsbury, the corporation in whose shares he traded. The government conceded before the magistrate judge that O'Hagan could not be prosecuted under Rule 10(b)-5 for failure to disclose the inside information to Pillsbury stockholders because he had no preexisting fiduciary duty to them and had done nothing to induce the officers and directors of Pillsbury to place their trust or confidence in him. Report and Recommendation of Magistrate Judge Cudd (Sept. 10, 1993), App. at 672-73. The magistrate judge's report and recommendation, adopted by the district court, concluded that "[a]s far as Pillsbury stockholders were concerned, Defendant was free under *Chiarella* and *Dirks* to use the alleged inside information as he saw fit." *Id.* at 673. Thus, our attention is focused solely on the misappropriation theory.

Supreme Court's teachings regarding the scope of conduct that may be regulated under that statute.

Neither the Supreme Court nor this court has yet determined whether the misappropriation theory is a permissible basis upon which to impose § 10(b) liability.[6] After carefully studying the Supreme Court's teachings on the scope of conduct reachable under § 10(b), however, coupled with the recent *Central Bank* ruling that the plain text of the statute controls this issue, we hold that § 10(b) liability cannot be based on the misappropriation theory. We reach this conclusion because, contrary to § 10(b)'s explicit requirements, the misappropriation theory does not require "deception," and, even assuming that it does, it renders nugatory the requirement that the "deception" be "in connection with the purchase or sale of any security."

We first turn our attention to the meaning ascribed to § 10(b) by the Supreme Court. That Court has repeatedly held that the deception prohibited under § 10(b) consists of the making of a material misrepresentation or the nondisclosure of material informa-

[6] In *Carpenter v. United States*, 484 U.S. 19, 24 (1987), an evenly divided Court affirmed a § 10(b) criminal conviction premised on the misappropriation theory, without expressing any views on the validity of the theory. Further, in *Chiarella*, 445 U.S. at 235-36, the Court declined to consider the government's argument that the misappropriation theory was a permissible basis upon which to affirm the defendant's § 10(b) conviction because such a theory had not been submitted to the jury.

With respect to this court, as far as we can tell, this is the only case in which the misappropriation theory of § 10(b) liability has been presented to us.

tion, in violation of a duty to disclose. *See, e.g., Central Bank*, 114 S. Ct. at 1446-48; *Santa Fe*, 430 U.S. at 470, 476. The *Santa Fe* Court, in fact, explicitly rejected the lower court's reading of § 10(b) which required no misrepresentation or nondisclosure. *Santa Fe*, 430 U.S. at 470-76. The *Central Bank* Court confirmed that misrepresentation or nondisclosure are requirements for § 10(b) liability. *See Central Bank*, 114 S. Ct. at 1448 ("As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act.").

Additionally, the Court has left no doubt that § 10(b) deception cannot be premised on the mere breach of a fiduciary duty, without an accompanying misrepresentation or lack of disclosure. *See id.* at 1446 ("deception" under § 10(b) does not encompass " 'breaches of fiduciary duty . . . without any charge of misrepresentation or lack of disclosure.' " (quoting *Santa Fe*, 430 U.S. at 470)). *See also Santa Fe*, 430 U.S. at 472 (to interpret "fraud" under Rule 10b-5 to extend to all breaches of fiduciary duty that are linked to a securities transaction would "add a gloss to the operative language of the statute quite different from its commonly accepted meaning.") (internal quotations omitted); *Dirks*, 463 U.S. at 654 ("Not all breaches of fiduciary duty in connection with a securities transaction . . . come within the ambit of Rule 10b-5. There must also be manipulation or deception.") (internal quotations omitted).

We reject the misappropriation theory, in part, because it permits the imposition of § 10(b) liability based upon the mere breach of a fiduciary duty

without a particularized showing of misrepresentation or nondisclosure. As previously stated, the misappropriation theory bases liability upon the mere misappropriation of material nonpublic information in breach of a fiduciary obligation and subsequent use of that information in a securities transaction. *Clark*, 915 F.2d at 443. By its very definition then, it does not require either a material misrepresentation or nondisclosure. Thus, the misappropriation theory runs counter to the *Santa Fe* and *Central Bank* holdings that the mere breach of a fiduciary obligation, without misrepresentation or nondisclosure, is not deception within the meaning of § 10(b). *See Bryan*, 58 F.3d at 949 (breach of fiduciary obligation without misrepresentation or nondisclosure does not constitute deception and thus conflicts with *Central Bank* and *Santa Fe*).

We need not tarry long on this point, however, because the misappropriation theory fails on another, more obvious, basis. The language of § 10(b) requires that the fraud be "in connection with the purchase or sale of any security." The misappropriation theory, however, permits liability for a breach of duty owed to individuals who are unconnected to and perhaps uninterested in a securities transaction, thus rendering meaningless the "in connection with . . ." statutory language. As noted by the Fourth Circuit, "The [Supreme] Court has left no doubt that the principal concern of section 10(b) is the protection of purchasers and sellers of securities." *Bryan*, 58 F.3d at 946-47. We agree. A careful reading of the Supreme Court's decisions in *Chiarella*, *Dirks*, and *Central Bank* reveals that only a breach of a duty to parties to the securities transaction or, at the most, to other

market participants such as investors, will be sufficient to give rise to § 10(b) liability.

This principle was explicitly stated in *Chiarella*. There, relying upon common law fiduciary principles, the Court held that one commits Rule 10b-5 fraud by failing to disclose material non public information in violation of a duty to disclose. *Chiarella*, 445 U.S. at 228. This duty to disclose, however, arises only "from a relationship of trust and confidence *between parties to a transaction*." *Id.* at 230 (emphasis added). The Court reiterated this point later in the opinion, stating that liability could be founded only on the breach of a fiduciary duty by "a person in whom the sellers had placed their trust and confidence." *Id.* at 232.

The *Dirks* Court reaffirmed this principle, stating "that '[a] duty [to disclose] arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market.'" *Dirks*, 463 U.S. at 657-58 (quoting *Chiarella*, 445 U.S. at 232-33). Although the Court referred only to "parties," rather than "parties to a transaction," as in *Chiarella*, the Court gave no indication that it intended to retreat from *Chiarella*'s holding. To the contrary, the *Dirks* Court stated early in its opinion that the duty to disclose crafted in *Chiarella* was applicable only to the corporation whose securities were being traded. *See id.* at 654 ("We were explicit in *Chiarella* in saying that there can be no duty to disclose where the person who has traded on inside information 'was not [the corporation's] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.'" (quoting *Chiarella*, 445 U.S. at 232)). The Court did indicate, however, that if § 10(b) was to be construed to reach beyond parties to the securities transaction, at the very most it extended to market participants, namely investors. *See id.* at 664 n.23 ("a violation [of § 10(b)] may be found only where there is 'intentional or willful conduct designed to deceive or defraud investors.'" (quoting *Ernst & Ernst*, 425 U.S. at 199)).

Finally, the *Central Bank* Court clearly placed the focus of § 10(b) on purchasers and sellers of securities: "Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which *a purchaser or seller of securities* relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met." 114 S. Ct. at 1455 (emphasis added). The Court also reaffirmed the principle it had set forth in *Dirks* that, if construed to reach beyond the purchasers and sellers to a securities transactions, § 10(b) at the very broadest can be read to reach only market participants. *See id.* at 1446 (stating that "the broad congressional purposes behind the [Securities] Act" is "to protect investors from false and misleading practices that might injure them."). *See also Bryan*, 58 F.3d at 948, 950 (if construed to reach beyond purchasers and sellers of securities, outer boundary of § 10(b) reaches no further than other market participants).

Against this venerable body of law, the misappropriation theory, which allows the imposition of § 10(b) liability even though no market participant was deceived or defrauded, cannot be defended. By evading the statutorily required nexus that the fraud

be "in connection with the purchase or sale of any security," the misappropriation theory essentially turns § 10(b) on its head, "transforming it from a rule intended to govern and protect relations among market participants" into an expansive "general fraud-on-the-source theory" which seemingly would apply to an infinite number of trust relationships. *Bryan*, 58 F.3d at 950; *see also id.* at 951 (observing that courts have applied the misappropriation theory to a wide variety of trust relationships and if taken to its logical conclusion would apply to case of simple theft by an employee). Such a wide ranging application of § 10(b) liability simply cannot be reconciled with the *Central Bank* holding that the text of § 10(b) governs the scope of conduct which may be regulated under that provision, coupled with the focus in *Chiarella*, *Dirks*, and *Central Bank* on parties to the securities transaction or, at most, other market participants. *See also id.* at 950 (the misappropriation theory "artificially divides into two discrete requirements—a fiduciary breach and a purchase or sale of securities—the single indivisible requirement of deception upon the purchaser or seller of securities, or upon some other person intimately linked with or affected by a securities transaction.").

The government contends that "[t]he in connection with element is met whenever a fraud touches the purchase or sale of a security, a standard which has been described as being very tenuous indeed." Gov. Br. at 48 n.37 (inner quotations omitted). This "touch" test stems from a passage in *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971), where the court stated, "The crux of the present case is that [the victim] suffered an injury as

a result of deceptive practices *touching* its sale of securities as an investor." (emphasis added). According to the government, the Court's use of "touch" demonstrates that the fraud need not be upon a party interested in a securities transaction.

We decline to ascribe such broad meaning to this single passage from *Bankers Life*. Such a sweeping interpretation appears to be inconsistent with the Court's statement in the immediately previous paragraph of *Bankers Life* that "we read § 10(b) to mean that Congress meant to bar deceptive devices and contrivances *in the purchase or sale of securities*." *Bankers Life*, 404 U.S. at 12 (emphasis added). More importantly, the victim of the fraud in *Bankers Life* was a seller of securities who was "injured as an investor." *Id.* at 10; *see also Bryan*, 58 F.3d at 950 n.17 (same). Finally, if this passage held the all-encompassing meaning the government attributes to it, then we cannot fathom how the defendants in the subsequent *Chiarella*, *Dirks*, and recently *Central Bank* cases escaped § 10(b) liability because each engaged in acts that "touched" the securities transaction.[7]

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[7] The government pointed out in oral argument that we have cited *Bankers Life* and employed its "touch" in several cases. *See Harris v. Union Elec. Co.*, 787 F.2d 355, 368 (8th Cir.), *cert. denied*, 479 U.S. 823 (1986); *United States v. Gruenberg*, 989 F.2d 971, 976 (8th Cir.) (quoting *Harris*), *cert. denied*, 114 S. Ct. 204 (1993). From this, the government contends that we have held that only a tenuous connection need be established between the fraud and the securities transaction, and applying that reasoning to this case, we must uphold O'Hagan's § 10(b) convictions. We have not held, however, nor could we in the face of the Supreme Court authority cited above, that the person defrauded need not be an individual who

Several of our sister circuits have concluded that § 10(b) liability may be predicated on the misappropriation theory, while the Fourth Circuit recently reached the opposite conclusion, rejecting outright the misappropriation theory as a basis for imposing § 10(b) liability. *See Bryan*, 58 F.3d at 933. We find the analysis from *Bryan* persuasive and have borrowed heavily from it in arriving at our conclusion. Therefore, we adopt that court's analysis in its entirety as our own.[8]

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has an interest or stake in a securities transaction. We simply held in these cases that the "touch" test is easily satisfied as long as the party defrauded is a market participant.

[8] *Bryan* was decided after the briefing had been completed in this case but prior to oral argument. The parties addressed the applicability of *Bryan* at oral argument. The government contends that *Bryan* holds that when information is misappropriated from a nonmarket participant, no fraud occurs under § 10(b); conversely when information is misappropriated from a market participant, fraud for the purposes of § 10(b) has occurred. In making this argument, the government contends that *Bryan* did not really depart from the holdings of other circuits and that no split in the circuits is present. We decline to read *Bryan* in the narrow fashion urged by the government. The *Bryan* court's holding rejected the misappropriation theory in sweeping terms. *See Bryan*, 58 F.3d at 944 ("We conclude that neither the language of section 10(b), Rule 10b-5, the Supreme Court authority interpreting these provisions, nor the purposes of these securities fraud provisions, will support convictions resting on the particular theory of misappropriation adopted by our sister circuits."). It did not, contrary to the government's contention, make a distinction between market v. nonmarket participants. In fact, had it done so, there would have been no need to explicitly disagree with the holdings from other courts which have adopted the misappropriation theory because the overwhelming majority of those cases has involved market participants.

We have read with care the cases in which our sister circuits, namely the Second,[9] the Seventh,[10] the Ninth,[11] and, arguably, the Third,[12] have adopted the misappropriation theory. With all due respect to these courts, for the most part, they seem to adopt the misappropriation theory without conducting a rigorous analysis of the text of § 10(b) and Supreme Court precedent. The genesis of the misappropriation theory, the Second Circuit's holding in *United States v. Newman*, 664 F.2d 12, 16-19 (2d Cir. 1981) (subsequent case history omitted), is emblematic. There, the court held that "deceitful misappropriation of confidential information by a fiduciary" was fraudulent under Rule 10b-5 and was "in connection with the purchase or sale of any security" because his "sole purpose in participating in the misappropriation of confidential takeover information was to purchase shares of the target companies." *Id.* at 18. However,

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[9] *See, e.g., United States v. Libera*, 989 F.2d 596, 599-600 (2d Cir.), *cert. denied sub nom. Sablone v. United States*, 114 S. Ct. 467 (1993); *United States v. Chestman*, 947 F.2d 551, 564 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992); *United States v. Newman*, 664 F.2d 12, 16-19 (2d Cir. 1981) (subsequent case history omitted).

[10] *See Sec v. Maio*, 51 F.3d 623, 631 (7th Cir. 1995); *Cherif*, 933 F.2d at 410.

[11] *See SEC v. Clark*, 915 F.2d at 453.

[12] *See Rothberg v. Rosenbloom*, 771 F.2d 818, 822 (3d Cir. 1985), *rev'd after remand*, 808 F.2d 252 (1986), *cert. denied*, 481 U.S. 1017 (1987). Courts that have discussed the misappropriation theory posit that the Third Circuit embraced it in *Rothberg*. We believe this is fairly debatable however, because the court devoted a mere paragraph to the principles underlying the theory, coupled with a citation to *Newman*. *Id.* at 822. In any event, we will assume for the purposes of this case that the *Rothberg* court adopted the theory.

the *Newman* court did not quote or discuss the language of § 10(b), did not cite *Santa Fe*, and only mentioned in passing the majority opinion in *Chiarella*. The court validated the misappropriation theory on the language of Rule 10b-5, Chief Justice Burger's dissent in *Chiarella*, and other areas of law in which the misappropriation of property has been held to be criminal. We take pause to note that the language of § 10(b), not Rule 10b-5, determines the scope of conduct the statute reaches. Additionally, Chief Justice Burger's position in *Chiarella* was espoused in a dissent and not the majority opinion.[13] Finally, the *Santa Fe* Court made clear that in construing § 10(b) resort could not be had to analogous federal statutes. *See Santa Fe*, 430 U.S. at 471-72 (court of appeals erred in relying on definition of fraud from other contexts in defining term in § 10(b) context); *see also Carpenter*, 484 U.S. at 24 (unanimously affirming defendant's mail fraud and wire fraud convictions based on same facts which divided the Court on § 10(b) conviction based on misappropriation theory).

Other courts that have recognized the misappropriation theory have either relied heavily on *Newman* or utilized interpretational methods which conflict with the Supreme Court's teachings on interpreting the scope of conduct encompassed by § 10(b). *See Rothberg*, 771 F.2d at 822 (relying solely on *Newman*); *Cherif*, 933 F.2d at 410 n.5 (relying on *Newman* and stating "[t]he more precise issues of statutory construction and legislative history have

[13] As we noted above, the *Chiarella* Court declined to address whether a misappropriation theory was valid because such a basis was not submitted to the jury.

been treated exhaustively elsewhere, and we decline to revisit them."); *Clark*, 915 F.2d at 443-53 (relying in part on *Newman* and also utilizing the meaning of fraud in other contexts). We note that neither *Cherif* nor *Clark* acknowledge *Santa Fe* in conducting their analysis. In essence, the courts which recognize the misappropriation theory seem to have validated it on the basis of the assumed unfairness of allowing an individual to trade securities on the basis of information which is not available to other traders. *See United States v. Carpenter*, 791 F.2d 1024, 1029 (2d Cir. 1986) (misappropriation theory permissible to give "legal effect to the commonsensical view that trading on the basis of improperly obtained information is fundamentally unfair. . . .") (citation and quotations omitted), *aff'd in part by evenly divided Court and rev'd in part*, 484 U.S. 19, 24 (1987). However, the Supreme Court has repeatedly held that the mere possession of material nonpublic information does not automatically create a duty to disclose. *See Chiarella*, 445 U.S. at 232 ("not every instance of financial unfairness constitutes fraudulent activity under § 10(b)"); *id.* at 235 ("We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information."); *Dirks*, 463 U.S. at 658 ("Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market."). The *Bryan* court undertook an exhaustive review of the opinions from these courts and concluded that these courts simply had given insufficient weight to the text of § 10(b) and improperly construed

the Supreme Court's pronouncements on the reach of that provision. We agree fully with that observation and, therefore, we respectfully decline to follow the holdings of our sister circuits which have adopted the misappropriation theory.

As the Supreme Court has said, the securities industry generally, and § 10(b) specifically, is "'an area that demands certainty and predictability'" and "decisions 'made on an ad hoc basis, offering little predictive value' to those who provide services to participants in the securities business'" are to be avoided. *Central Bank*, 114 S. Ct. at 1454 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)). The misappropriation theory undermines this interest by permitting liability to be imposed in a wide variety of circumstances involving a breach of fiduciary duty, presumably including a simple employee theft. *See Bryan*, 58 F.3d at 951-52 (outlining myriad of fiduciary situations in which the misappropriation theory has been applied). In essence, the theory creates "'a shifting and highly fact-oriented disposition of the issue of who may [be liable for] a damages claim for violation of Rule 10b-5.'" *Central Bank*, 114 S. Ct. at 1454 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 755 (1975)). *See also Blue Chip Stamps*, 421 U.S. at 737 (Court described burgeoning of liability in § 10(b) area as "a judicial oak which has grown from little more than a legislative acorn."); *United States v. Chestman*, 947 F.2d 551, 564 (2d Cir. 1991) (en banc) (Winter, J., concurring in part and dissenting in part) (describing liability under § 10(b) for insider trading and stating that "caselaw establishes that some trading on material nonpublic information is illegal and some is not. The line between

the two is less than clear."), *cert. denied*, 503 U.S. 1004 (1992).[14] In this light, we think the misappropriation theory cannot be countenanced.[15]

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[14] Perhaps the paradigmatic example of the attenuated circumstances in which a § 10(b) conviction based on the misappropriation theory has been obtained is *United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y.), *appeal dismissed*, 778 F. Supp. 205 (S.D.N.Y. 1991). There, the government charged that the defendant, a psychiatrist, breached a physician-patient duty of confidentiality when he traded securities based on material, nonpublic information supplied by a patient that her husband was interested in becoming the CEO of BankAmerica. 737 F. Supp. at 270-72. In sustaining the defendant's conviction, the court held that under the misappropriation theory, § 10(b) liability was not limited only to situations in which the breach of the fiduciary relationship implicates the securities markets. 778 F. Supp. at 208-09.

[15] The misappropriation theory has also been criticized by commentators, primarily for the very reasons we reject the theory today. *See* Michael P. Kenny & Teresa D. Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)*, 59 Alb. L. Rev. 139 (1995); David C. Bayne, *The Insider's Natural Law Duty: Chestman and the "Misappropriation Theory"*, 43 U. Kan. L. Rev. 79 (1994). *See also* John R. Beeson, Comment, *Rounding the Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory*, 144 U. Pa. L. Rev. 1077, 1138 (1996). The Beeson article gives a perfect example of the ad-hoc basis on which the theory is employed, offering by way of example two individuals who obtain material, nonpublic information, on which they subsequently trade securities. One can be prosecuted under § 10(b) while the other cannot, based simply on the fact that the individual who may be prosecuted traded on the information in violation of a breach of a fiduciary duty while the other individual received the information fortuitously. *See* Beeson, 144 U. Pa. L. Rev. at 1078-79. These two individuals call to mind the Supreme Court's statement in *Chiarella* that "a duty to disclose under § 10(b) does not arise

Accordingly, we hold that the misappropriation theory is not a valid basis upon which to impose criminal liability under § 10(b). Thus, because O'Hagan's convictions for securities fraud under § 10(b) and Rule 10b-5 in Counts 21-37 were premised solely on the misappropriation theory, these convictions must be vacated.

B.

O'Hagan also challenges his securities fraud convictions under § 14(e) of the Securities Exchange Act and Rule 14e-3. Section 14(e) provides:

> It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer. . . . The [SEC] shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

15 U.S.C. § 78n(e). The first sentence in § 14(e) was enacted in 1968 as part of the Williams Act. *Chestman*, 947 F.2d at 564. "'The purpose of the Williams Act is to insure that public shareholders who are confronted by a cash tender offer for their stock will not be required to respond without adequate information.'" *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 8 (1985) (quoting *Rondeau v. Mosinee*

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from the mere possession of nonpublic market information." 445 U.S. at 235.

Paper Corp., 422 U.S. 49, 58 (1975)). *See also Piper v. Chris-Craft Indus.*, 430 U.S. 1, 35 (1977) ("The legislative history thus shows that the sole purpose of the Williams Act was the protection of investors who are confronted with a tender offer."). Thus, the focus of § 14(e) is on the shareholders of the company who are or will be confronted with a tender offer. The purpose of § 14(e) is to "add[] a broad antifraud prohibition modeled on the antifraud provisions of § 10(b) of [the Securities Exchange Act of 1934] and Rule 10b-5. . . ." *Schreiber*, 472 U.S. at 10 (inner quotations and citations omitted).

The second sentence of § 14(e) is a rulemaking provision that was enacted in 1970, two years after the original Williams act. *Chestman*, 947 F.2d at 564. Accordingly, the SEC promulgated Rule 14e-3(a) in 1980, which provides:

> (a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive, or manipulative act or practice within the meaning of section 14(e) of the [Securities Exchange] Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:
>
> (1) The offering person,
>
> (2) The issuer of the securities sought or to be sought by such tender offer, or

> (3) Any officer, director, partner, or employee or any other person acting on behalf of the offering person or such issuer,
>
> to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its sources are publicly disclosed by press release or otherwise.

17 C.F.R. § 240.14e-3(a).

"Rule 14e-3(a) is a disclosure provision." *Chestman*, 947 F.2d at 557. An individual violates the rule when "he trades on the basis of material nonpublic information concerning a pending tender offer that he knows or has reason to know has been acquired 'directly or indirectly' from an insider of the offeror or issuer, or someone working on their behalf." *Id.* (quoting Rule 14e-3(a)). Thus, the rule creates a duty to disclose this information, or to abstain from trading, "regardless of whether such information was obtained through a breach of fiduciary duty." *SEC v. Maio*, 51 F.3d 623, 631 (7th Cir. 1995); *see also SEC v. Peters*, 978 F.2d 1162, 1166-67 (10th Cir. 1992) (holding breach of fiduciary relationship not required to establish violation of Rule 14e-3); *Chestman*, 947 F.2d at 557 (Rule 14e-3(a) "creates a duty in those traders who fall within its ambit to abstain or disclose, without regard to whether the trader owes a pre-existing fiduciary duty to respect the confidentiality of the information.").

O'Hagan contends that his securities fraud convictions under § 14(e) and Rule 14e-3(a) must be vacated because the SEC exceeded its rulemaking authority when it promulgated Rule 14e-3(a). Specifically, O'Hagan claims that the SEC impermissibly redefined fraud in Rule 14e-3(a) by omitting the requirement that a breach of a fiduciary duty must be shown because the term fraud under § 14(e) requires a breach of fiduciary duty.

An administrative rule exceeds its statutory mandate if it is "inconsistent with the statutory mandate or . . . frustrate[s] the policy that Congress sought to implement." *Securities Indus. A'ssn v. Board of Governors*, 468 U.S. 137, 143 (1984) (inner quotations and citation omitted). To date, three courts have considered whether the SEC exceeded its rulemaking authority when it promulgated Rule 14e-3 without the requirement of a breach of a fiduciary duty. *See Maio*, 51 F.3d at 634-35; *Peters*, 978 F.2d at 1165-67; *Chestman*, 947 F.2d at 556-63. These courts have all concluded that the SEC did not exceed its authority. After carefully reviewing these decisions and considering them in light of the text of § 14(e) and the Supreme Court's holdings in *Chiarella* and *Schreiber*, we conclude that we must depart from the holdings of our sister circuits and hold that the SEC exceeded its rulemaking authority by enacting Rule 14e-3(a) without including the requirement of a breach of a fiduciary duty.

Because this issue turns on the scope of conduct that may be regulated by § 14(e), once again the plain language of the statute is controlling. *See Central Bank*, 114 S. Ct. at 1446-48 (with respect to determining the scope of conduct prohibited by § 10(b), "the

text of the statute controls our decision"). Although the *Central Bank* Court dealt with scope of conduct prohibited by § 10(b), the Court stated unequivocally that its textual analysis applied to all provisions in the Securities Act. *See id.* at 1447 ("Adherence to the text in defining the conduct covered by § 10(b) is consistent with our decisions interpreting other provisions of the securities Acts."). This methodology is in line with that employed by the *Schreiber* Court where, in the context of interpreting the term "manipulative" under § 14(e), the Court turned to the language of the statute. *See* 472 U.S. at 6 ("[t]he starting point is the language of the statute.").

We thus turn our attention to the text of § 14(e). Specifically, we focus on the second sentence of that provision, the enabling provision. It provides in pertinent part: "The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent. . . ." Eliminating those words having no bearing to our inquiry, the statute empowers the SEC to "define" and "prescribe means reasonably designed to prevent" "acts and practices" which are "fraudulent." Thus, by dissecting the language and structure of the statute, it becomes clear that the terms "define" and "prescribe" relate to "acts and practices" meeting the statutory definition of "fraudulent."

A straightforward exercise in statutory construction then affords no basis for concluding that § 14(e) authorizes the SEC to create its own definition of fraud in implementing the statute. Simply put, the enabling provision of § 14(e) permits the SEC to identify and regulate those "acts and practices"

which fall within the § 14(e) legal definition of "fraudulent," but it does not grant the SEC a license to redefine the term. *See Chestman*, 947 F.2d at 584 (Mahoney, J., concurring in part and dissenting in part) ("the plain meaning of the dispositive language is that the SEC is empowered to identify and regulate, in this (then) novel [tender offer] context, the 'acts and practices' that fit within the existing legal categories of the 'fraudulent, deceptive, or manipulative,' but not to redefine the categories themselves.").

The government takes issue with this reading of § 14(e), claiming that the plain language is a broad delegation to the SEC of rulemaking powers and, when properly read, it empowers the SEC to "define" and "prescribe means reasonably designed to prevent" "fraudulent conduct" in the tender offer context. In essence, the government conflates the language of the statute into a broad empowerment to the SEC to "define" and "prescribe" "fraud." As we point out above, however, this is not what the plain language of § 14(e) delegates to the SEC; the enabling provisions simply permit the SEC to "define" and "prescribe" "acts and practices" which meet § 14(e)'s meaning of "fraudulent."

We thus must ascertain the meaning of "fraudulent" in § 14(e). The Congress gave no indication that the term was to have a meaning different from its common legal definition. *See id.* ("Furthermore, these venerable terms are used in their normal, accepted definitions."). The *Schreiber* Court looked to the common law and dictionary definitions in defining manipulation. *See Schreiber*, 472 U.S. at 7 (court construed "manipulative" in manner consistent with its common law and dictionary defini-

tion). Black's Law Dictionary provides certain definitions of "fraud" which are entirely consistent with the breach of a fiduciary duty, while other definitions would impose no such requirement. *Compare Black's Law Dictionary* 660 (6th ed. 1990) ("concealment of that which should have been disclosed," and "acts, omission, and concealments involving a breach of a legal or equitable duty") *with id.* ("An intentional perversion of truth for the purpose of inducing another in reliance upon it," "A false representation of a matter of fact," and "A generic term, embracing all multifarious means which human ingenuity can devise"). Thus, the dictionary definitions provide little assistance in resolving this problem. However, the analytic model created by the Supreme Court's holdings in *Schreiber* and *Chiarella*, cases drawing heavily on common law principles, leads to the inescapable conclusion that fraudulent under § 14(e) must be read to include a breach of a fiduciary duty.

In *Schreiber*, the Court explicitly held that § 14(e) is modeled after the broad antifraud provisions of § 10(b) and Rule 10b-5. 472 U.S. at 10 & n.10. Moreover, in the course of interpreting manipulation, the Court turned to the meaning that term had been given under § 10(b), noting that "Congress used the phrase 'manipulative or deceptive' in § 10(b) as well, and we have interpreted 'manipulative' in that context to require misrepresentation." *Id.* at 7-8 & n.6. The Court went on to note that "[a]ll three species of misconduct, *i.e.*, 'fraudulent, deceptive, or manipulative,' listed by Congress are directed at failures to disclose." *Id.* at 8. Accordingly, the definition that fraudulent has been given under § 10(b) and Rule 10b-5 guides our interpretation of the term under § 14(e).

As we observed during our discussion of § 10(b), the *Chiarella* Court drew upon common law concepts in defining fraud under § 10(b), holding that the term encompassed a failure to disclose information but only if there was a duty to speak. 445 U.S. at 222, 235. This duty to speak, in turn, arises out of a " 'fiduciary or other similar relation of trust and confidence.' " *Id.* at 228 (quoting Restatement (Second) of Torts § 551(2)(a) (1976)).

Reading *Schreiber* and *Chiarella* together leads to the conclusion that "fraudulent" under § 14(e) includes the breach of a fiduciary obligation. Initially, we note that § 10(b) and § 14(e) are contained in the same statutory enactment, the Securities Exchange Act of 1934—strong evidence that the terms are to be given the same meaning. *See Gustafson v. Alloyd Co., Inc.*, 115 S. Ct. 1061, 1067 (1995) (term "prospectus" construed to have the same meaning in § 10 of the 1933 Securities Act as in § 12 of that same Act); *see also id.* (in holding that "identical words used in different part of the same act are intended to have same meaning," Court stated "[t]he Securities Act of 1933, like every Act of Congress, should not be read as a series of unrelated provisions."). That § 10(b) does not specifically include the term fraud is of no moment because it is beyond cavil that that provision is a powerful antifraud provision. *Chiarella*, 445 U.S. at 234-35. Further, the *Schreiber* Court turned directly to § 10(b) to define terms in § 14(e), and *Chiarella* held that fraudulent under § 10(b) requires the breach of a fiduciary obligation. Of added import, the *Schreiber* Court held that "fraudulent" under § 14(e) was directed at nondisclosure of information, while the *Chiarella* Court detailed the circumstances

under which nondisclosure is fraudulent under § 10(b). Additionally, we also think it significant that the *Chiarella* Court turned to common law concepts in giving meaning to fraudulent under § 10(b), as did the *Schreiber* Court in interpreting manipulative under § 14(e).

Finally, we also find telling that, in the quote from *Chiarella* in the above paragraph, the Supreme Court quoted the Restatement (Second) of Torts and then stated that the American Law Institute views this rule as applicable to "securities transactions." *See Chiarella*, 445 U.S. at 228 n.9 ("As regards securities transactions, the American Law Institute recognizes that 'silence when there is a duty to . . . speak may be a fraudulent act.'" (quoting ALI, Securities Code § 262(b) (Prop. Off. Draft 1978)). It is inexplicable to us why this Restatement rule, should have definitive force in the § 10(b) context but not in the § 14(e) context, especially in light of the fact that the two sections are part of the same statutory scheme. *See Chestman*, 947 F.2d at 586-87 (Mahoney, J., concurring in part and dissenting in part). Accordingly, we hold that *Schreiber* and *Chiarella* mandate that "fraudulent" under § 14(e) must be interpreted to require the breach of a fiduciary obligation or similar trust relationship.[16]

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[16] Additionally, some commentators have indicated that the rationale from *Bryan*, 58 F.3d at 943-59, with respect to the misappropriation theory under § 10(b), also calls into doubt the validity of Rule 14e-3(a). Richard M. Phillips & Gilbert C. Miller, *Litigation Reform in the Courts: Limiting Section 12(2) Liability, The Bespeaks Caution Doctrine and the Misappropriation Theory*, CA28 ALI-ABA 487, 527 (February 16, 1996) ("Indeed, under the [*Bryan*] court's rationale, it is by no means clear that SEC Rule 14-3 would be upheld to preclude transactions in the securities of target companies by insiders of tender offerors.").

The government does not explicitly address the force of *Chiarella* and *Schreiber* on this issue, instead arguing that if the authority granted to the SEC to define fraud is circumscribed to simply applying the meaning that term is given in the § 10(b) context, the SEC really has no authority at all under the statute. We disagree. As we noted above, the SEC does not have the authority to define fraud; rather, the plain language of § 14(e) permits the SEC to define and prescribe preventive measures for acts and practices which are fraudulent. Moreover, this grant of authority to the SEC, even without the power to define fraud, remains a very powerful tool because the SEC has broad latitude in regulating acts and practices in the wide ranging and diverse field of tender offers. Finally, and most importantly, we think *Schreiber* is a strong rebuttal to this argument because there the Court looked directly at § 10(b) to define manipulative under § 14(e). 472 U.S. at 7-8.

The government also points out that the language in § 14(e), granting the SEC rulemaking authority, is different from that in § 10(b), arguing that the § 14(e) language grants the SEC much broader rulemaking powers than under § 10(b). We believe, however, the government makes too much of what in reality are simply minor discrepancies in language between the two provisions. Section 10(b) permits the Commission to create "rules and regulations" which are "necessary or appropriate in the public interest or for the protection of investors," while § 14(e) empowers the Commission to enact "rules and regulations" which "define" and "prescribe means reasonably de-

signed to prevent" "acts and practices" which are "fraudulent." In the end, although perhaps § 14(e) is the product of clearer legislative draftsmanship, the authority granted to the SEC under both provisions is fundamentally the same. *See Chestman*, 947 F.2d at 587 (Mahoney, J., concurring in part and dissenting in part) (positing that minor discrepancies in statutory language of § 10(b) and § 14(e) are of no significance).[17]

Finally, the government contends that the meaning of "fraudulent" under § 14(e) is irrelevant in deciding this issue because of the statutory language authorizing the SEC "to prescribe means reasonably designed to prevent" the acts and practices which are fraudulent. The government argues that under this language, the SEC may regulate conduct which is not fraudulent in order to prevent the commission of a fraudulent act. The government points to a passage from a footnote in *Schreiber*, where the Court stated that the enabling provision in § 14(e) empowered the

[17] We also note that to the extent that the *Chestman* majority relied on the statements of a subsequent Congress in interpreting § 14(e), such a method of interpretation was condemned by the Supreme Court in *Central Bank*. There, the court made clear that using statements of a later Congress to interpret a statute enacted by an earlier Congress is to be avoided, at least in the area of securities law. *See Central Bank*, 114 S.Ct. at 1452 ("[T]he interpretation given by one Congress (or committee or Member thereof) to an earlier statute is of little assistance in discerning the meaning of that statute."). As the government correctly observes, however, the *Chestman* majority first relied on the text of the statute to reach its conclusion, and thus it is unclear how much weight the majority gave to this evidence. *See Chestman*, 947 F.2d at 558.

SEC to "regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts. . . ." 472 U.S. at 11 n.11. However, the government fails to include the remainder of this sentence from *Schreiber*, which states, "without suggesting any change in the meaning of the term 'manipulative' itself." *Id.* Properly read, this provision means simply that the SEC has broad regulatory powers in the field of tender offers, but the statutory terms have a fixed meaning which the SEC cannot alter by way of an administrative rule.

We take pause to observe, as the government points out, that "[b]ecause Congress has expressly granted the SEC authority to promulgate rules which will implement section 14(e), rules promulgated under that section have 'legislative effect' and are 'entitled to more than mere deference. . . .'" (Gov't's Br. at 53 (quoting *Batterton v. Francis*, 432 U.S. 416, 425-26 (1977).) Thus, the government continues, we may not set aside these rules simply because we would have interpreted § 14(e) in a manner different from the SEC, but only if the rule is inconsistent with the statutory mandate or frustrates the Congressional policy sought to be implemented.

While the government's point is well made, nonetheless, an administrative agency's interpretation of a statute under which it has been given rulemaking authority is not wholly beyond reproach. In this vein, the Supreme Court observed in *IBT v. Daniel*, 439 U.S. 551, 566 n.20 (1979), that "[T]his deference is constrained by our obligation to honor the clear meaning of a statute, as revealed by its language, purpose, and history. On a number of occasions in recent years this Court has found it neces-

sary to reject the SEC's interpretation of various provisions of the Securities Acts." *See also Aaron v. SEC*, 446 U.S. 680, 694 n.11 (1980) (rejecting SEC's view that scienter is not required in § 10(b) injunctive proceedings); *Business Roundtable v. SEC*, 905 F.2d 406, 407 (D.C. Cir. 1990) (holding that SEC exceeded its statutory authority in promulgating Rule 19c-4 to bar national securities exchange and associations from listing stocks violative of one share/one vote principle). We conclude that, in this instance, the SEC has once again acted in excess of its statutory authority.

We hold that the SEC exceeded its rulemaking authority under § 14(e) when it promulgated Rule 14e-3(a) without including a requirement of a breach of a fiduciary obligation. Accordingly, we must vacate O'Hagan's securities fraud convictions under these provisions.

C.

O'Hagan was also convicted on a number of counts of mail fraud and money laundering. The essential elements of the crime of mail fraud are: (1) a scheme to defraud, or to obtain money or property by false pretenses, and (2) use of the mails to further the scheme. *United States v. Wicker*, 80 F.3d 263, 267 (8th Cir. 1996). The mere fact that O'Hagan's securities convictions have been reversed does not as a matter of law require that the mail fraud convictions likewise be reversed. *See Carpenter*, 484 U.S. at 24 (unanimously affirming mail and wire fraud convictions based on the same facts that evenly divided the Court on the defendant's securities fraud convictions); *Bryan*, 58 F.3d at 936 (affirming mail fraud and wire fraud counts but reversing on securities fraud

counts). However, in the present case, the indictment was structured in such a manner as to premise the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud. (*See* R. at 697-706.) Because O'Hagan's conduct did not constitute securities fraud for the reasons we have noted above, there was no fraud upon which to base the mail fraud charges. Accordingly, we reverse O'Hagan's mail fraud convictions.

With regard to the money laundering counts, they were predicated on the securities fraud or mail fraud counts. Because we have vacated all of the securities fraud and mail fraud counts, there no longer remain any convictions to serve as the predicate conduct upon which to base the money laundering counts. We therefore must reverse these convictions as well. *See* 18 U.S.C. §§ 1956-1957 (requiring the property involved in the transaction to be derived from or the proceeds of unlawful activities).

III.

Our ruling today should in no manner be understood as condoning O'Hagan's conduct. From the record, it appears as though O'Hagan, then an attorney at law, engaged in at least some transactions in Pillsbury securities after learning privileged, confidential information that his law firm was representing a client intending a takeover of Pillsbury. Such conduct is certainly unethical and immoral and must be condemned, which we make haste to do. We note that O'Hagan was disbarred in Minnesota, and served a 30-month sentence after being convicted in Minnesota state court for invading clients' trust funds. However, it is a fundamental principle of the criminal law that not every ethical or moral trans-

gression falls within its realm. This case is a prime example of that principle. Accordingly, for the reasons enumerated above, we reverse O'Hagan's securities fraud, mail fraud, and money laundering convictions and remand this case to the district court for dismissal of the indictment.

FAGG, Circuit Judge, dissenting.

My colleagues have carefully analyzed both sides of the relevant legal coins and selected the sides that nullify O'Hagan's convictions. Contrary to their well-reasoned views, I would recognize and adopt the misappropriation theory like the Second, Seventh, Ninth, and Third Circuits, *see ante* at 620 & nn. 9-12, and thus uphold O'Hagan's convictions for securities fraud under § 10(b) and Rule 10b-5. *United States v. Libera*, 989 F.2d 596, 599-600 (2d Cir.), *cert. denied sub nom. Sablone v. United States*, 114 S. Ct. 467 (1993); *SEC v. Maio*, 51 F.3d 623, 631 (7th Cir. 1995); *SEC v. Clark*, 915 F.2d 439, 453 (9th Cir. 1990); *Rothberg v. Rosenbloom*, 771 F.2d 818, 822 (3d Cir. 1985), *rev'd after remand*, 808 F.2d 252 (1986), *cert. denied*, 481 U.S. 1017 (1987). Also, like the Second, Seventh, and Tenth Circuits, *see ante* at 623-24, I would hold the Securities Exchange Commission did not exceed its rulemaking authority when it enacted Rule 14e-3(a) without the requirement of a breach of a fiduciary duty, and thus uphold O'Hagan's securities fraud convictions under § 14(e) and Rule 14e-3(a). *United States v. Chestman*, 947 F.2d 551, 556-63 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992); *Maio*, 51 F.3d at 634-35; *SEC v. Peters*, 978 F.2d 1162, 1165-67 (10th Cir. 1992). Having adopted these views, I find no basis to reverse O'Hagan's convictions for mail fraud and money laundering. *See ante* at 31-32.

Because I would affirm all of O'Hagan's convictions, I would also consider the merits of the government's appeal from O'Hagan's sentences.

APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
FOURTH DIVISION

Crim. No. 4-92-219

UNITED STATES OF AMERICA, PLAINTIFF

v.

JAMES HERMAN O'HAGAN, DEFENDANT

[Filed: Sept. 10, 1993]

REPORT AND RECOMMENDATION

Defendant was present in court with his counsel, Charles Hawkins. The government was represented by Assistant United States Attorneys Lynn Zentner and Christopher Bebel. Attorneys Jan Struumans, Terrence Fruth and Vincent Louwagie, who all have represented Defendant, testified on his behalf.

Before the Court are Defendant's motion to dismiss the indictment and his supplemental motion to dismiss the indictment. Defendant is charged with misappropriation of material, non-public information concerning the acquisition of The Pillsbury Company by Grand Metropolitan, PLC and subsequently making a series of purchases on the securities markets based on this insider information. The indictment alleges in:

a) Counts 1-20 that Defendant committed mail fraud in violation of 18 U.S.C. § 1341 by receiving through the mail twenty confirmation slips;

b) Counts 21-37 that Defendant committed securities fraud in violation of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78ff(a) and 17 C.F.R. § 240.10b-5, by breaching his duty of trust and confidence owed to Grand Met and the Dorsey & Whitney law firm by misappropriating information concerning Grand Met's tender offer for Pillsbury stock and trading on that information in the securities market;

c) Counts 38-54 that Defendant committed securities fraud in violation of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78n(e) and 78ff(a) and 17 C.F.R. § 240.14e-3(a), by trading in Pillsbury stock after substantial steps were taken by Grand Met in its takeover attempt, while in possession of material, non-public information concerning the tender offer; and

d) Counts 55-57 that Defendant engaged in money laundering in violation of 18 U.S.C. § 1957 (Count 55), and 18 U.S.C. § 1956(a)(1)(B)(i) (Counts 56-57) by the wire transfer of funds derived from mail fraud and fraud in the sale of securities, and by obtaining cashier's checks to replace embezzled funds, which sums involved the proceeds from the mail and securities fraud perpetrated by Defendant, all with the intent to conceal and disguise the proceeds of Defendant's unlawful activity.

Defendant moves to dismiss all Counts, 1-57, of the indictment on the grounds that:

a) The Counts are barred on the grounds of double jeopardy by his civil case, pending in this Court;

b) The Counts violate principles of federalism and the "*Petite* Policy" of *Petite v. United States*, 361 U.S. 529 (1960), which counsels against bringing a federal prosecution following a state prosecution based on substantially the same act or acts unless there is a compelling federal interest;

c) The Counts are the result of prosecutorial vindictiveness;

d) There has been preindictment delay; and

e) The information obtained by Defendant was public and immaterial as a matter of law.

Defendant moves to dismiss Counts 1-20 on the grounds that these Counts fail to state an offense because: 1) the indictment fails to allege that either Dorsey & Whitney or Grand Met were deprived of any property as required by the mail fraud statute, 18 U.S.C. § 1341; and 2) because the confirmation slips Defendant received from his brokers were not mailings in furtherance of the alleged fraud.

Defendant moves to dismiss Counts 21-37 on the grounds that these Counts fail to state an offense because: 1) Section 10(b) of the Securities Exchange Act of 1934 does not criminalize insider trading; and 2) the indictment alleges only a breach of a duty of trust and confidence owed to Grand Met and the Dorsey & Whitney law firm, not a duty owed to Pillsbury shareholders.

Defendant moves to dismiss Counts 21-54 on the grounds that: 1) these Counts are barred by the applicable statute of limitations; and 2) these Counts are multiplicitous and should be consolidated into two or three Counts.

Defendant moves to dismiss Counts 38-54 on the grounds that: 1) the SEC exceeded its rulemaking authority in promulgating Rule 14e-3 under which

Defendant is charged; and 2) these Counts fail to state an offense because they do not allege that Grand Met took substantial steps toward the takeover of Pillsbury.

Defendant moves to dismiss Counts 55-56 for failure to state an offense because neither mail fraud nor securities fraud were defined as "specified unlawful activity" in 1988, pursuant to the money laundering statutes under which Defendant is charged.

BACKGROUND

The indictment charges that Defendant violated federal laws against insider trading, mail fraud and money laundering. It is alleged that Defendant, while a partner at the Dorsey & Whitney law firm, misappropriated material, non-public information concerning the acquisition of The Pillsbury Company by Grand Metropolitan, PLC and subsequently made a series of purchases on the securities markets based on this insider information. Defendant denies these allegations.

At the hearing, Defendant's former attorneys in the SEC civil suit testified concerning essentially two subjects. First, the attorneys testified that they believed Defendant would be indicted perhaps as much as two years earlier than he was indicted. However, they admitted that the government made no such affirmative representations. Second, the attorneys testified that glob[al] settlement negations were conducted, but failed, and that attempts to have the government forego prosecution in light of Defendant's state conviction had not been successful. In this regard, the testimony was that the prosecutor had stated that Defendant had been an attorney, had enjoyed societ[y's] benefits and his crimes were many

and involved millions of dollars. The prosecuting attorney is reported to have noted that, compared to less privileged members of society, who might rob a bank, gain only $500.00 and yet be sentenced to 15 to 20 years in prison, Defendant had little to complain about.

DISCUSSION

DOUBLE JEOPARDY

Defendant argues that all Counts, 1-57, are barred by double jeopardy. Defendant contends his SEC civil case, pending in this Court, bars his criminal prosecution. This Court is not persuaded.[1]

The double jeopardy clause bars further prosecution only if jeopardy attached in the initial proceeding. *See Serfass v. United States*, 420 U.S. 377, 388, 391 (1975). Jeopardy does not attach until a jury is empaneled and sworn or in a non-jury trial, when the court begins to hear evidence. *Id.* at 388 and 391. Neither predicate event has occurred in the instant case as the civil proceedings have been stayed. Defendant's argument that the extent of discovery should cause jeopardy to attach is rejected.

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[1] While Defendant was also prosecuted in state court the separate sovereigns doctrine defeats any claim of double jeopardy in regard to the state prosecution vis-a-vis the federal prosecutions. *See Abbate v. United States*, 359 U.S. 187 (1959); *Rinaldi v. United States*, 434 U.S. 22, 28 (1977). While Defendant raises the possibility that the separate sovereigns doctrine is no longer valid after *Grady v. Corbin*, 110 S.Ct. 2084 (1990), *Grady* has recently been overruled by the United States Supreme Court. *United States v. Dixon*, 1993 WL 224417 (June 28, 1993).

FEDERALISM AND PETITE v. UNITED STATES, 361 U.S. 529 (1960)

Defendant contends that all Counts, 1-57, of the indictment must be dismissed because this prosecution violates the principles of federalism and the *Petite* policy of the Justice Department as set forth in *Petite v. United States*, 361 U.S. 529, 530-31 (1960). The *Petite* policy is a general internal guideline of the Department of Justice that counsels against bringing a federal prosecution following a state prosecution based on substantially the same act or acts unless there is a compelling federal interest. As this "policy" is an internal procedural guideline, it cannot be enforced against the government. *United States v. Woodward*, 927 F.2d 433, 435 (8th Cir.), *cert. denied*, 112 S. Ct. 246 (1991); *United States v. Robinson*, 774 F.2d 261, 275 (8th Cir. 1985).

Defendant's federalism argument is equally flawed. Violation of federal laws and statutes is distinct from violation of state laws. *See United States v. Jacobs*, No. 92-3696 (8th Cir. September 1, 1993) (*per curiam*) ("The fact that the federal government prosecutes a federal crime in federal court that could have or has been prosecuted as a state crime in a state court does not itself violate due process."). Finally, this Court has found that this indictment does not raise double jeopardy concerns.

PROSECUTORIAL VINDICTIVENESS

Defendant contends that all Counts, 1-57, should be dismissed for prosecutorial vindictiveness. Defendant is grasping at straws.

Negotiations were conducted between Defendant's attorney and the prosecuting attorney in an attempt to resolve all of the charges facing Defendant. These

global settlement negotiations were unsuccessful. Subsequently, Defendant changed attorneys and these attorneys met with the prosecuting attorney in an attempt to have the government abandon its prosecution of Defendant, in part because they felt Defendant had been punished enough. The government refused and in response to the attorneys' queries noted that Defendant had been an attorney, had enjoyed societ[y's] benefits and that his crimes were many and involved millions of dollars. The prosecuting attorney went on to note that compared to less privileged members of society, who might rob a bank, gain only $500.00 and yet be sentenced to 15 to 20 years in prison, Defendant had little to complain about. On this thin reed, Defendant bases his argument of vindictive prosecution.

A defendant may demonstrate vindictive prosecution by either: (1) proving through objective evidence that the prosecutor's decision was intended to punish him for the exercise of a legal right; or (2) by relying on a presumption of vindictiveness. *See United States v. Beede*, 974 F.2d 948, 951 (8th Cir. 1992), *cert. denied*, ___ U.S. ___, 113 S. Ct. 1016 (1993). A rebuttable presumption of vindictiveness may arise when a prosecutor increases the number or severity of charges. *See United States v. Punelli*, 892 F.2d 1364, 1371 (8th Cir. 1990). Absent such a presumption, Defendant has the burden of proving vindictiveness. *Id.* at 1372.

As the *Beede* court recognized, prosecutorial vindictiveness is not shown where plea negotiations fail and the prosecutor goes ahead with the prosecution. *See United States v. Beede*, 974 F.2d at 951 (citing *Bordenkircher v. Hayes*, 434 U.S. 357 (1978) and *United States v. Goodwin*, 457 U.S. 368, 382-83

(1982)). Moreover, "'A prosecutor should remain free before trial to exercise the broad discretion entrusted to him to determine the extent of the societal interest in prosecution.'" *Id.* at 952 (citing *United States v. Goodwin*, 457 U.S. 368, 382 (1982)). These principles govern this case.

Defendant attempted to negotiate a global settlement and attempted to persuade the prosecuting attorney to drop the charges against him. Defendant's efforts failed. This Court finds that no prosecutorial vindictiveness is proven by the government going forward with Defendant's prosecution.

When asked why the government would not forego prosecution in light of Defendant's state conviction, the prosecutor explained the societal interest in prosecuting Defendant. This Court finds that the prosecutor's statement shows no improper motive.

Correspondingly, this Court finds that no presumption of vindictiveness has arisen in this case and Defendant has failed to prove that the prosecutor's decision was intended to punish him for the exercise of a legal right. This Court also notes that Defendant has failed to identify the right whose exercise is allegedly being punished (failure to reach a negotiated settlement being insufficient), and has failed to establish that there was an increase in the number of severity of charges after exercise of such right. Alternatively, assuming *arguendo* that a presumption of vindictiveness has been established, this Court finds that the presumption has been successfully rebutted by the government, as the prosecutor properly considered societal interests in prosecution.

DELAY

Defendant contends that all Counts, 1-57, should be dismissed for preindictment delay. Defendant is in error. The only evidence in support of Defendant's argument is the testimony of Defendant's former attorneys in the SEC civil proceeding. These attorneys formulated a belief that Defendant would be indicted in the near future. The government made no representations in this regard.

In *United States v. Purham*, 725 F.2d 450, 453 (8th Cir. 1984) the Eighth Circuit stated that:

> [P]reindictment delay may violate the due process clause. *United States v. Lovasco*, 431 U.S. 783, 789-90 (1977); *United States v. Marion*, 404 U.S. 307, 324 (1971). 'A defendant is entitled to dismissal of an indictment where he [or she] shows *actual* prejudice from an *unreasonable* delay on the part of the government. Where actual prejudice is established, the reasons for the delay are balanced against the prejudice shown by the accused.' *United States v. Taylor*, 603 F.2d 732, 735 (8th Cir.) (citations omitted; emphasis in the original), *cert. denied*, 444 U.S. 982 (1979).

Assuming for the purposes of argument that the delay of more than a year between the date of the crime and the filling of the federal indictment was unreasonable, a careful review of the record convinces us that the district court correctly found that appellant did not demonstrate actual prejudice. Appellant has relied solely on the admittedly 'real possibility of prejudice inherent in any extended delay: that memories will dim, witnesses become inaccessible, and evidence be lost . . .

> [T]hese possibilities are not in themselves enough to demonstrate that [appellant] cannot receive a fair trial and to therefore justify the dismissal of the indictment.' *United States v. Marion*, 404 U.S. at 326; *see United States v. Hendricks*, 661 F.2d 38, 40 (5th Cir. 1981); *United States v. Taylor*, 603 F.2d at 735. (Footnote omitted).

Dismissal may also be appropriate if a defendant can show that the delay was an intentional device used by the government to gain tactical advantage over the accused and caused substantial prejudice to his right to fair trial. *United States v. Jackson*, 714 F.2d 809, 811 (8th Cir. 1983). "The ultimate question in determining whether a deliberate or reckless delay is 'tactical' is whether it is engineered to impair the defendant's ability to mount an effective defense by causing him to lose evidence." *United States v. Dennis*, 625 F.2d 782, 794 (8th Cir. 1980).

Defendant has failed to demonstrate any actual prejudice from the delay in bringing the indictment against him. Similarly, Defendant has failed to show that any delay was tactical. In the absence of actual prejudice, Defendant's motion must fail.

FAILURE TO STATE AN OFFENSE—CHARACTER OF INFORMATION

Defendant contends that all Counts, 1-57, must be dismissed for failure to state an offense because the information obtained by Defendant, concerning Grand Met's tender offer, was public and immaterial as a matter of law. Whether information is material is a question of fact to be decided by the trier of fact. *See TSC Indus. v. Northway*, 426 U.S. 438, 450 (1976); *Berg v. First American Bankshares, Inc.*, 796 F.2d 489, 494-95 (D.C. Cir. 1986); *SEC v. Singer*, 786 F.

Supp. 1158, 1172 (S.D.N.Y. 1992). The materiality and nonpublic nature of the information Defendant obtained are elements of the government's case-in-chief which must be proven at trial. On this record, this Court finds that ultimate resolution of these issues must be left to the trier of fact.[2]

FAILURE TO STATE AN OFFENSE—MAIL FRAUD

Defendant contends that the mail fraud counts, 1 through 20, must be dismissed because they fail to allege that he obtained money or property from Grand Met or Dorsey & Whitney, an essential element of the crime. Defendant's motion appears to raise two issues: first, whether the counts allege that Defendant obtained property from Grand Met and Dorsey & Whitney, and second, whether the property allegedly obtained is property as that term is used in 18 U.S.C. § 1341.

We turn to the allegations of the indictment. Count 1 sets forth the scheme. Paragraph 2 alleged Defendant engaged in a scheme to defraud Grand Met and Dorsey & Whitney by trading in Pillsbury, Inc. common stock, while in possession of material nonpublic information about Grand Met's future tender offer for Pillsbury common stock. In paragraph 14, it is alleged that Defendant, a partner in the firm of Dorsey

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[2] Defendant in his supplemental motion to dismiss revisits these issues arguing that Counts 21-54 of the Indictment must be dismissed "based upon the failure to charge an offense because the defendant did not possess any material non-public information at the time he placed the orders for the purchase of Pillsbury common stock and options identified in the indictment." *See* Defendant's Supplemental motion to Dismiss. Again these issues must be left to the trier of fact. This Court will not presage their decision.

& Whitney, learned his firm was retained by Grand Met to represent them in connection with tender offers and then purchased Pillsbury stock and call options, which he later sold at a profit after the tender offer became public information.

The allegations, read together and given a common sense interpretation, allege that Defendant defrauded Grand Met and Dorsey & Whitney by using, without permission, their confidential business information, before it became public, to trade in Pillsbury stock. Defendant's argument that the indictment fails to allege an essential element of the offense must be rejected.

In resolving the second issue, it must be determined whether the tender offer information was property within the meaning of the mail fraud statute. Defendant relies on *McNally v. United States*, 483 U.S. 350 (1987). In *McNally*, the Supreme Court held that the public's interest in honest and impartial government is not property within the meaning of the mail fraud statute. Defendant's apparent contention is that confidential information is not property subject to the mail fraud statute under *McNally*.

Defendant's premise was rejected in *Carpenter v. United States*, 484 U.S. 19 (1987). In *Carpenter*, the Supreme Court held that confidential business information is property within the scope of the mail fraud statute. *Id.* at 28. In *Carpenter*, the defendants had used information on the publication date and contents of a Wall Street Journal article to trade in the market, based on the probable impact on the market when the article was published. The distinction between *McNally* and *Carpenter* is not between tangible and intangible property, but between those interests which do not constitute property and those interests

that are either tangible or intangible property. *United States v. Grandberry*, 908 F.2d 278, 280 (8th Cir. 1990).

Under *Carpenter* Grand Met's confidential business information is property protected by the mail fraud statute. Law firms have a property interest in keeping information confidential to retain and gain clients. *United States v. Grossman*, 843 F.2d 78, 86 (2d Cir. 1988). Dorsey & Whitney also has a property interest protectable under the mail fraud statute. Defendant's motion must be denied at this time. The issue of whether the business information was confidential and misappropriated must await proof at trial.

FAILURE TO STATE AN OFFENSE—NOT IN FURTHERANCE

Defendant next moves to dismiss all of the mail fraud counts, 1 through 20, on the ground that the mailings alleged in each count were not in furtherance of the scheme to defraud as required by the mail fraud statute, 18 U.S.C. § 1341. Each count alleges the mailing to Defendant from his broker of a confirmation of Pillsbury stock or call option purchases. Defendant argues that the stock purchases were on record with his brokers and the confirmation slips were not required to prove ownership, nor were they ever used by him for any purpose, and thus did not further the scheme.

Defendant relies on *Kann v. United States*, 323 U.S. 88 (1944); *Parr v. United States*, 363 U.S. 370 (1960); *Maze v. United States*, 414 U.S. 395 (1974); and *United States v. Taylor*, 789 F.2d 618 (8th Cir. 1986). In *Kann*, the court held that mailing a check from the bank that cashed it to the drawee bank was not in

furtherance of a scheme to defraud because defendants had the money and it was immaterial to them whether the bank, which paid the check, could collect from the drawee bank. *See also United States v. Taylor, supra.* In *Parr* and *Maze*, the Supreme Court held that credit card invoices, mailed after the goods and services had been obtained, were not in furtherance of the scheme to defraud. In both cases, it was immaterial to the defendant whether the invoices were mailed, since he had completed his scheme.

The above cases are distinguishable from the instant case. The scheme here alleges that the Defendant bought Pillsbury stock based on confidential information and sold it later, when the information became public and drove up the price of the stock. The scheme alleged was therefore only half complete when the stocks were purchased. Businesses, including stock brokers, make errors when executing and recording transactions. The slips confirming the purchases would be important to settle disputes over the fact of or the amount of stock purchased. The slips would also be important in determining which blocks of stock or call options to sell in order to maximize profits when the price began to rise.

The Second Circuit in *United States v. Grossman*, 843 F.2d 78, 89 (2d Cir. 1988) held that confirmation slips were sent in furtherance of a scheme to defraud because:

> 1) They provided notification that the purchase was complete; 2) provided a tally of purchase, and 3) provided proof of ownership.

Defendant attempts to distinguish *Grossman* because the slips in that case were sent to defendant's rela-

tives to conceal ownership. The principles of *Grossman* are applicable, however, because of the factors listed above. Defendant's motion to dismiss because the confirmation slips were not in furtherance of the conspiracy must be denied.

FAILURE TO STATE AN OFFENSE—CRIMINALITY

Defendant contends that Counts 21-37 must be dismissed for failure to state an offense because Section 10(b) of the Securities Exchange Act of 1934 does not criminalize insider trading. This Court rejects Defendant's argument. Two cases are illustrative of this point.

In *United States v. Lang*, 766 F. Supp. 389, 399 (D. Md. 1991), the District Court found that insider trading was criminalized under Rule 10b-5, rejecting the type of argument that Defendant advances. More critically, in *SEC v. O'Hagan*, 793 F. Supp. 218, 221 (D. Minn. 1992), the District Court found that Rule 10b-5 prohibits insider trading, where the defendant argued that the SEC's claims were implied under *Lampf*, because Rule 10b-5 did not specifically prohibit insider trading. Given the confluence of *Lang* and *O'Hagan*, this Court must reject Defendant's argument. While Defendant criticizes the decision in *Lang*, in light of *O'Hagan*, it appears that the rule in this district is that Section 10(b), through the application of Rule 10b-5, criminalizes insider trading.

FAILURE TO STATE AN OFFENSE—FIDUCIARY DUTY

Defendant moves to dismiss Counts 21 through 37, which allege insider trading, because the counts fail to charge that he breached a fiduciary duty or other relationship of trust and confidence to Pillsbury stockholders, the target of Grand Met's takeover

offer. Defendant was neither an officer or director, nor did his law firm represent Pillsbury. Absent such a relationship, he argues he was free to trade in Pillsbury stock without disclosure of allegedly confidential information. The government counters Defendant violated Rule 10(b)-5, when he breached a duty to Grand Met and Dorsey & Whitney, its law firm, by misappropriating their confidential business information and using it to trade in the market.[3]

The Securities and Exchange Commission (SEC) in *In the matter of Cady, Roberts & Co.*, 40 S.E.C. 907 (1961) ruled that a corporate insider, who has material nonpublic information, must under Rule 10(b)-5 abstain from trading in his corporate stock unless he discloses the information known to him. The Supreme Court accepted and applied the principles of *Cady, Roberts* in *United States v. Chiarella*, 445 U.S. 222 (1980). In *Chiarella*, documents relating to a takeover bid had been sent to a company for printing. One of the printing company's employees deciphered the identity of the target company and profited from

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[3] Rule 10(b)-5, codified at 17 C.F.R. § 240-10b-5 (Employment of manipulative and deceptive devices), states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which there were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud of deceit upon any person, in connection with the purchase or sale of any security.

trading in its stock, without disclosing the information he had learned. The court held there was no general requirement to disclose inside information, when trading in the market. *United States v. Chiarella*, 445 U.S. 222, 229 (1980). The Supreme Court reversed the criminal conviction for violating Rule 10(b)-5 because the printer, absent a fiduciary duty or a relationship of trust and confidence to the shareholders of the target company, owed no duty to disclose his information. The majority in *Chiarella* rejected the government's invitation to affirm the convictions because the printer had breached his duty to the tender offeror by misappropriating the information. In their view, the theory was not presented to the jury.

The SEC contended in *Dirks v. SEC*, 463 U.S. 464 (1983) that a broker, who received material nonpublic information from corporate officers and employees, which he gave to some of his customers, who traded in the stock, was in violation of Rule 10(b)-5. The SEC censured Dirks for the violation. The Supreme Court said at page 665:

> It is undisputed that Dirks himself was a stranger to Equity Funding with no preexisting fiduciary duty to its shareholders. He took no action, directly or indirectly, that enticed the shareholders or officers of Equity Funding to repose trust or confidence in him. There was no expectation by Dirks' sources that he would keep their information in confidence nor did Dirks misappropriate or illegally obtain the information about Equity Funding. Unless the insiders breached their *Cady, Roberts* duty to shareholders in disclosing the nonpublic information to Dirks, he breached no duty, when he passed it on to investors . . .

The court went on to hold that the tippers in *Dirks* did not breach any duty to Equity Funding shareholders and concluded, therefore, that Dirks, the tippee, was not in violation of Rule 10(b)-5.

Under the principles of *Chiarella* and *Dirks*, the government concedes Defendant cannot, as he contends, be prosecuted under Rule 10(b)-5 for failure to disclose inside information to Pillsbury stockholders. Defendant had no preexisting fiduciary to them, and he did nothing to induce the officers and directors of Pillsbury to place their trust and confidence in him. As far as Pillsbury stockholders were concerned, Defendant was free under *Chiarella* and *Dirks* to use the alleged inside information as he saw fit.

We turn to the question of whether Defendant violated Rule 10(b)-5 if, as charged, he breached a duty by misappropriating Grand Met's and Dorsey & Whitney's confidential business information, and without disclosure, used it to trade in Pillsbury stock. Stated another way, the question is whether Defendant can be convicted if neither the seller nor the buyer of securities was defrauded.

The Supreme Court has not addressed this question. As set forth above, the question was not answered in *Chiarella* or *Dirks*. In the former, because the issue was not presented to the jury. In the later, because there was no claim of misappropriation of information. In *Carpenter v. United States*, 484 U.S. 19 (1987), an equally divided court affirmed without opinion a Rule 10(b)-5 criminal conviction for the misappropriation of confidential business information of the Wall Street Journal, and its use to trade in the market based upon the impact on the market when the information became public. The misappropriation theory of insider trading posits that Rule 10b-5

prohibits the purchase or sale of securities while in possession of material, nonpublic information if it is a breach of a fiduciary duty owed to the source of the information, whether or not that source was involved in the security transaction and whether or not there was a breach of duty to any purchaser or seller. It is under this broader theory of insider trading that the government charges Defendant. While the Eighth Circuit has not specifically adopted the misappropriation theory, other circuits have.

In *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983), two employees at the Kuhn Loeb investment banking firm:

> Misappropriated confidential information concerning proposed mergers and acquisitions that was entrusted to their employers by corporate clients. This information was conveyed to Newman, a securities trader and manager of the over-the-counter trading department of a New York brokerage firm. Newman passed along the information to two confederates . . . [T]he three conspirators purchased stock in companies that were takeover targets . . . They then reaped substantial gains when the mergers or takeovers were announced and the market price of the stock rose.

United States v. Newman, 664 F.2d 12, 15 (2d Cir. 1981). The district court dismissed the securities fraud charges because it concluded the federal securities laws did not proscribe the defendants' conduct. In reversing the district court, the Second Circuit reasoned, first, that § 10(b) was written as both a regulatory and criminal piece of legislation, going on to note that, "The courts, not the Congress, have limited Rule 10(b)-5 suits for damages to the purchas-

ers and sellers of securities. The district court's statement that fraud perpetrated upon purchasers or sellers of securities is a 'requisite element under the securities laws' is, therefore, an overbroad and incorrect summary of the law." *Id.* at 17. The court than noted that a plaintiff, "need not be a defrauded purchaser or seller in order to sue for injunctive relief under Rule 10(b)-5." *Id.* Finding that the defendants had wronged both the investment firm and their clients by misappropriating the confidential information, the court concluded:

> In other areas of law, deceitful misappropriation of confidential information by a fiduciary, whether described as theft, conversion, or breach of trust, has consistently been held to be unlawful. (citations omitted). Appellee would have had to be most ingenuous to believe that Congress intended to establish a less rigorous code of conduct under the Securities Acts. (citations omitted).

Id. at 18.

In *Rothberg v. Rosenbloom*, 771 F.2d 818 (3rd Cir. 1985), *cert. denied*, 481 U.S. 1017 (1987), officer and director, David Rosenbloom obtained information that his company, Nytronics, intended to merge with Gulton Industries. Rosenbloom conveyed this information to Rothberg, who invested on the basis of this information. The trial court held that Rosenbloom breached a duty to his own company, whether or not be breached a duty to Gulton shareholders.

On appeal, it was contended that, "with respect to the Gulton transaction, he was an outsider and could not have violated § 10(b), relying on *Chiarella*." *Id.* at 822. The Third Circuit found *Chiarella* inapposite, holding that Rosenbloom owed a fiduciary duty to his

own company, Nytronics, "not to disclose secret information which would cause others to buy Gulton stock, thereby making it more difficult for Nytronics to consummate a merger on favorable terms." *Id.* Citing *Newman*, the court upheld the trial court, holding that: "An insider on either side of a proposed transaction violates the insider trading rule when he uses insider information in violation of the fiduciary duty owed to the corporation to which he owes a duty of confidentiality." *Id.*

In *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990), Clark was president of Rolyan Manufacturing. Rolyan was acquired by Smith & Nephew, plc, (S&N), a British concern. S&N employed Clark as part of an acquisitions team to find new companies for S&N to acquire. Through his employment with S&N, Clark discovered that S&N intended to acquire Affiliated Heath Products (AHP). Acting on the basis of this information, Clark arranged to purchase AHP stock in anticipation of the takeover. In the trial court, Clark was found in violation Rule 10(b)-5 under a misappropriation theory. On appeal, the Third Circuit stated that, "Our task is to determine whether Congress, in enacting § 10(b), empowered the SEC to promulgate rules which would encompass the misappropriation theory. In addition, we must determine whether Rule 10b-5 was drafted such that the theory may legitimately be implied." *SEC v. Clark*, 915 F.2d 439, 443 (9th Cir. 1990).

Discussing *Newman*, *Rothberg* and a number of other cases upholding the misappropriations theory, the Court upheld the application of the misappropriation theory reasoning:

1. Rule 10(b)-5 is a "catchall" antifraud provision, *id.* at 448;

2. The misappropriation theory fits "comfortably" within the concept of fraud in § 10(b) and Rule 10(b)-5, *id.* at 449;

3. Clark's actions were in connection with the purchase or sale of any security because, "Clark's sole purpose in obtaining the non-public information about SN's plans to acquire AHP was to make a fast buck by trading in securities," *id.*;

4. "[T]he scant legislative history on § 10(b) contains no indication that the misappropriation theory is out of step with congressional intent." *Id.* at 450. The court found the same to be true for Rule 10(b)-5; and

5. Looking to the passage of the Insider Trading and Securities Fraud Enforcement Act of 1988, the court found that Congress had manifested a belief that the misappropriation theory was consistent with § 10(b) and Rule 10(b)-5, noting the House Report on this legislation. *Id.* at 452.

The Ninth Circuit concluded that:

> The "peculiar blend of legislative, administrative, and judicial history" surrounding § 10(b) and Rule 10(b)-5, (citation omitted), provides strong evidence that the misappropriation theory is compatible with the broad language of those provisions. Although the Supreme Court has yet to recognize the theory, (footnote omitted) we nonetheless adopt it as it was prosecuted in this case. Specifically, we hold that an employee's knowing misappropriation and use of his employer's material nonpublic information regarding its intention to acquire another firm constitutes a violation of § 10(b) and Rule 10(b)-5.

* * *

> [While] Clark . . . claims that adopting the theory in this case would introduce a "parity-of-information" rule which has been previously rejected by the Supreme Court as inconsistent with § 10(b) and Rule 10(b)-5, *see Dirks*, 463 U.S. at 654, 103 S.Ct. at 3261; *Chiarella*, 445 U.S. at 233, 100 S.Ct. at 1117. (footnote omitted). We disagree. The misappropriation theory, as we have adopted it today, applies only where the misappropriation occurs by means of a violation of fiduciary or similar duty. (footnote omitted). Thus it does not run afoul of Supreme Court precedent.

Id. at 453.

In *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991), *cert. denied*, ___ U.S. ___, 112 S.Ct. 966 (1992), Cherif was employed by First National Bank of Chicago. After being terminated from his employment, Cherif retained his magnetic identification card, which he used to enter the building. Using this card, Cherif gained unauthorized access to the building after his termination and obtained confidential information from the Specialized Finance Department. Cherif then traded on this information.

In upholding the application of the misappropriation theory to Cherif, the Seventh Circuit stated:

> The misappropriation theory has won adherents in numerous circuit and district courts despite the lack of explicit approval from the Supreme Court. The bulk of the cases have arisen in the Second Circuit, (citations, to include *Newman*, omitted), but the theory has now been adopted by the Third and Ninth Circuits. (citations to *Clark* and *Rothberg* omitted). District courts in other circuits have welcomed the theory, too. *SEC v. Peters*, 735 F. Supp. 1505 (D. Kan. 1990); *United States v. Elliott*, 711 F. Supp. 425 (N.D. Ill. 1989).

We join these courts in holding that a person violates Rule 10b-5 and Section 10(b) of the Securities Exchange Act of 1934 by misappropriating and trading upon material information entrusted to him by virtue of a fiduciary relationship such as employment. There is a common sense notion of fraud behind the misappropriation theory. As the *Clark* court put it:

> [By] becoming part of a fiduciary or similar relationship, an individual is implicitly stating that she will not divulge or use to her own advantage information entrusted to her in the utmost confidence. She deceives the other party by playing the role of the trustworthy employee or agent; she defrauds it by actually using the stolen information to its detriment.

Clark, 915 F.2d at 448. We agree that buying or selling securities "in connection with" fraud perpetrated on an employer to obtain material nonpublic information constitutes a violation of Rule 10b-5. (footnote omitted).

SEC v. Cherif, 933 F.2d 403, 410 (7th Cir. 1991). The court applied the theory, even though Cherif was not employed by First National at the time he misappropriated the confidential information.[4]

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[4] The Court noted:

> Cherif was bound by a broader common law duty. This common law duty obligates an employee to protect any

Most recently, the Second Circuit has reaffirmed *Newman*, upholding convictions where:

> Appellant's convictions are based on the so-called misappropriation theory arising out of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b). (footnote omitted). Sitting *in banc*, we recently restated that theory[:] "[O]ne who misappropriated nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage violates Section 10(b) and Rule 10b-5." *United States v. Chestman*, 947 F.2d 551, 564 (2d Cir. 1991) (*in banc)* (citation omitted), *cert. denied*, ___ U.S. ___, 112 S.Ct. 1759,

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> confidential information entrusted to him by his employer during his employment. In addition, an employee is obligated to continue to protect such information after his termination.
>
> * * *
>
> Cherif breached a continuing duty to his former employer when he used the key card and specific, confidential knowledge he had learned about First Chicago as an employee to break into the bank immediately after termination and steal inside information about upcoming transactions. It makes no difference that Cherif carried out the thefts formally after his employment ended. The confidential property and information he came to possess during his tenure at the bank provided the foundation for the success of the subsequent break-ins. Cherif attained his objective of obtaining deal-specific information by wrongfully converting other confidential information entrusted to him by First Chicago. His trades were "in connection with" a fraudulent scheme to gain access to material, non-public information possessed by first Chicago. This is all the nexus that Rule 10b-5 requires.

Id. at 411.

118 L. Ed. 2d 422 (1992); *see also id.* at 576 ("[L]ower courts have added to the *Dirks* [*v. SEC*, 463 U.S. 646, 103 S.Ct. 3255, 77 L. Ed. 2d 911 (1983),] breach of duty doctrine a misappropriation of information doctrine, which prohibits trading in securities based on material, nonpublic information acquired in violation of a duty to any owner of such information, whether or not the owner is the corporation whose shares are traded.") (Winter J., concurring and dissenting opinion). We have found the requisite fiduciary duty in the employer/employee context. (citation omitted). We have also noted that "the misappropriation theory does not require that the buyer or seller of securities be defrauded." *Chestman*, 947 F.2d at 566. Rather, "the predicate act of fraud may be perpetrated on the source of the nonpublic information, even though the source may be unaffiliated with the buyer or seller of securities." *Id.* This fraud has been analogized to embezzlement, *see Carpenter*, 791 F.2d at 1033 n. 11, and may simply be thought of as the misuse, by trading, of stolen information. *See Chestman*, 947 F.2d at 578 (Winter, J., concurring and dissenting opinion).

United States v. Libera, 989 F.2d 599-600 (2d Cir. 1993). This Court is persuaded by the reasoning of the cases from the Second, Third, Seventh and Ninth Circuits adopting the misappropriation theory. This Court finds that Defendant can be convicted of having violated Rule 10(b)-5 if, as charged, he breached a duty by misappropriating Grand Met's and Dorsey & Whitney's confidential business information, and without disclosure, used it to trade in Pillsbury stock, even

though neither the seller nor the buyer of securities was defrauded.[5]

STATUTE OF LIMITATIONS

Defendant argues that the securities fraud Counts, 21-54, must be dismissed because they are barred by the statute of limitations. The conduct at issue in these Counts took place in August and September of 1988. The pending indictment was handed down on December 17, 1992. Defendant argues that the applicable statute of limitations is that announced in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 111 S. Ct 2773, 2782 (1991); one year after

[5] Defendant's subsidiary argument that the misappropriation theory invades the exclusive province of state law is without foundation. While state law may well regulate Defendant's acquisition of the confidential information at issue, and the ethical propriety of such actions, federal law addresses the use of that information. Defendant cites no Minnesota statutory scheme that will be disrupted by the application of Rule 10(b)-5 to Defendant's use of the confidential information. The fraud encompassed by Section 10(b) and Rule 10b-5 extends to conduct which touches the purchase or sale of securities. *See Superintendent of Ins. v. Bankers Life & Cas.*, 404 U.S. 6, 12-13 (1971); *see also United States v. Gruenberg*, 898 F.2d 971 (8th Cir. 1993). This touching requirement has been interpreted broadly and reaches Defendant's conduct. *See SEC v. Cherif*, 933 F.2d at 411; *SEC v. Clark*, 915 F.2d at 449; *United States v. Newman*, 664 F.2d at 18.

Similarly, Defendant's argument that Section 10(b) and Rule 10b-5 are void for vagueness with respect to the misappropriation theory because they do not provide fair notice of prosecution and violate due process has been rejected. *See United States v. Newman*, 664 F.2d at 19; *United States v. Lang*, 766 F. Supp. at 402. In light of the cases discussed, *supra*, this Court must agree.

discovery and within three years after the violation. The government argues that the applicable statute of limitations is five years, as set out in 18 U.S.C. § 3282. This Court finds that *Lampf* is inapplicable to this case and the appropriate statute of limitations is that set out at 18 U.S.C. § 3282.

The Supreme Court's decision in *Lampf* only applies to private actions based on Section 10(b) of the Securities Exchange Act of 1934. This is the context in which *Lampf* arose and the Court noted that "in this litigation we must determine which statute of limitations is applicable to a *private* suit brought pursuant to § 10(b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U.S.C. § 78j(b), and to Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10-b-5 (1990), promulgated thereunder." *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 111 S. Ct. 2773, 2776 (1991) (emphasis added). As the instant suit is brought by the government, *Lampf* is inapplicable.

Moreover, *Lampf* applies only to implied, not express, causes of action. *Id.* at 2779-80. This Court has found that "[A]n SEC enforcement action is . . . express, not implied, regardless of whether judicial interpretation has broadened the rule which the SEC seeks to enforce." *SEC v. O'Hagan*, 793 F. Supp. 218, 221 (D. Minn. 1991). As this action is an SEC enforcement action it is express and *Lampf* has no application.

As the 1934 Act does not provide for a specific statute of limitations the catch-all five year statute of limitations for offenses not capital, 18 U.S.C. § 3282, applies. *See e.g., United States v. Vogt*, 910 F.2d 1184, 1195 (4th Cir. 1990) (RICO); *United States v. Thomas*, 887 F.2d 1341, 1349 (9th Cir. 1989) (Lacey Act); *United*

States v. Pepe, 747 F.2d 632, 663 (11th Cir. 1984) (RICO); *United States v. Sloan*, 389 F. Supp. 526, 528 (S.D.N.Y. 1975) (Exchange Act); *United States v. Bloom*, 78 F.R.D. 591, 598 (E.D. Pa. 1977) (same).

MULTIPLICITY OF COUNTS

Defendant contends that Counts 21-54 are multiplicitous and should be consolidated into two or three counts. Defendant is in error. Multiplicitous counts charge a single offense in several counts. *See United States v. George*, 986 F.2d 1176, 1179 (8th Cir. 1993). Defendant argues that he only made three stock orders and only once formulated the intent to commit fraud. Therefore, he reasons, the counts reflecting the purchases, as carried out by his brokers, are multiplicitous. Defendant's allegations are unproven assertions of fact that will ultimately be determined at trial.

Assuming, *arguendo*, that Defendant's characterization of his behavior is true, the Counts are not multiplicitous. In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730-31 (1975), the Supreme Court identified the actual purchase or sale of a security as the operative event for purposes of Section 10(b) liability. Thus, the intent to commit fraud and the placement of the orders by themselves are irrelevant as orders do not violate Section 10(b) without a purchase or sale taking place. The general principle of charging a defendant with each sale of a security as a separate offense has been upheld by the Eighth Circuit. *See United States v. Naftalin*, 606 F.2d 809, 810 (8th Circuit 1979) (prosecution under Section 17(a) of the Securities Act of 1933); *see also United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y. 1990).

SEC'S AUTHORITY TO PROMULGATE RULE 14e-3

Defendant contends that Counts 38-54 of the indictment, charging Defendant with violating Section 14e and Rule 14e-3 of the 1934 Act, must be dismissed because the SEC exceeded its rulemaking authority in promulgating Rule 14e-3. Section 14e provides in pertinent part:

> (e) It shall be unlawful for any person to . . . engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer . . . The Commission shall, for purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive or manipulative.

15 U.S.C. § 78n(e).

Rule 14e-3 reads in pertinent part:

> (a) If any person has taken a substantial step or steps to commence, or has commenced a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of Section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from: . . .

> (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

17 C.F.R. § 240.14e-3(a). Defendant's argument has been considered and rejected. *See United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991); *United States v. Marcus Schloss & Co., Inc.*, 710 F. Supp. 944 (S.D.N.Y. 1989). This Court finds these cases persuasive and declines Defendant's invitation to find that these cases were wrongly decided.

FAILURE TO STATE AN OFFENSE—SUBSTANTIAL STEPS

Defendant contends that Counts 38-54 of the indictment must be dismissed for failure to state an offense because the indictment fails to allege that Grand Met took substantial steps toward the takeover of Pillsbury, as required by Rule 14e-3. *See supra*. Defendant is in error. The indictment alleges that Grand Met formulated an intent to takeover Pillsbury and then set about taking steps to implement that plan to include soliciting advice and arranging for financing. *See* Indictment, Docket No. 1, pp. 14-15.

While Defendant argues that, since no specific price is referenced, no substantial steps can be found to have been taken, this argument is unsupported by case law and defies common sense. Similarly, Defendant's argument that, due to evidence relating to Grand Met's financing of the takeover, the steps undertaken by Grand Met cannot be considered substantial, is premature, being clearly an issue for trial.

FAILURE TO STATE AN OFFENSE—UNLAWFUL ACTIVITY

Defendant contends that Counts 55-56 must be dismissed for failure to state an offense because neither mail fraud nor securities fraud were defined as "specified unlawful activity" in 1988, pursuant to the money laundering statutes under which Defendant is charged, 18 U.S.C. § 1957 (Count 55) and 18 U.S.C. § 1956(a)(1)(B)(i) (Counts 56 and 57). Defendant is in error.

Defendant committed his alleged illegal acts in August and September of 1988. As of that time 18 U.S.C. § 1956(c)(7)(A) defined the necessary predicate acts for liability under the statute to include any act listed in 18 U.S.C. § 1961(1). Similarly, as of that time 18 U.S.C. § 1957(f) (3) defined the necessary predicate acts for liability under the statute as the same as those in § 1956, thus including any act listed in 18 U.S.C. § 1961(1).

As of the date of Defendant's alleged illegal activity, § 1961(1) included the mail fraud statute, § 1341, and any offense involving "fraud in the sale of securities." "Fraud in the sale of securities" includes conduct proscribed by Section 10 and Rule 10b-5. *See e.g., James v. Meinke*, 778 F.2d 200, 204-05 (5th Cir. 1985);

Ohman v. Kahn, 685 F. Supp. 1302, 1309-10 (S.D.N.Y. 1988) (RICO). Thus, Defendant's argument does not hold water as both mail fraud and fraud in the sale of securities were defined as "specified unlawful activity" in 1988, pursuant to the money laundering statutes under which Defendant is charged, 18 U.S.C. § 1957 (Count 55) and 18 U.S.C. § 1956(a)(1)(B)(i) (Counts 56 and 57).

RECOMMENDATION

Accordingly, **IT IS HEREBY RECOMMENDED** that Defendant's motion to dismiss the indictment and his supplemental motion to dismiss be **DENIED**.

/s/ J. EARL CUDD
HON. J. EARL CUDD
UNITED STATES MAGISTRATE JUDGE

Dated: Sept. 10, 1993

Pursuant to Local Rule 72.1(c) any party may object to this Report and Recommendation by filing with the Clerk of the Court, and serving all parties within ten (10) days, a writing which specifically identifies those portions of this Report to which objections are made and the basis of those objections. Failure to comply with this procedure shall operate as a forfeiture of the objecting party's right to seek review in the Court of Appeals.

Unless the parties are prepared to stipulate that the District Court is not required by 28 U.S.C. § 636 to review a transcript of the hearing in order to resolve all objections made to this Report and Recommendation, the party making the objections shall timely order and cause to be filed a complete transcript of the hearings.

APPENDIX C

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
FOURTH DIVISION

No. 4-92-CR-219

UNITED STATES OF AMERICA

v.

JAMES HERMAN O'HAGAN

[FILED: DEC. 30, 1993]

ORDER

This matter is before the Court on appeal from Reports and Recommendations issued by the Honorable J. Earl Cudd, United States Magistrate Judge, on September 1, 1993, and September 10, 1993. In the September 1, 1993, report, the magistrate recommended that defendant's motion to dismiss Counts 21 through 54 of the indictment for improper venue be denied. The September 10, 1993, report recommended that defendant's motion to dismiss the indictment be denied. As part of this report and recommendation, the magistrate ruled, *inter alia*, that the Double Jeopardy Clause of the Fifth Amendment did not bar this prosecution. The defendant filed objections to the report and recommendations, pursuant to Local Rule 72.1(c).

Based upon a *de novo* review of the record herein, the Court adopts the magistrate's reports and recommendations.

* * * * *

Conclusion

For the reasons set forth above, and based on all files, records, and proceedings, IT IS ORDERED that:

1. Defendant's motion to dismiss Counts 21 through 54 of the indictment for improper venue is denied.

2. Defendant's motion to dismiss the indictment, and his supplemental motion to dismiss, is denied.

3. Jury selection in this matter will commence, as previously determined, on January 3, 1994, and trial will commence January 11, 1994.

Dated: December 30th, 1993

/s/ JAMES M. ROSENBAUM
JAMES M. ROSENBAUM
United States District Judge

APPENDIX D

UNITED STATES COURT OF APPEALS
EIGHTH CIRCUIT

Nos. 94-3714, 94-3856MNMI

UNITED STATES OF AMERICA,
PLAINTIFF-APPELLEE/CROSS-APPELLANT

v.

JAMES HERMAN O'HAGAN,
DEFENDANT-APPELLANT/CROSS-APPELLEE

[Filed: Nov. 13, 1996]

ORDER DENYING PETITION FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC

The suggestion for rehearing en banc is denied. Judge McMillian would grant the suggestion.

The petition for rehearing by the panel is also denied.

Chief Judge Richard S. Arnold, Judge Magill, Judge Loken, and Judge Murphy took no part in the consideration or decision of these cases.

Order Entered at the Direction of the Court:

/s/ MICHAEL E. GANS
MICHAEL E. GANS
Clerk, U.S. Court of
Appeals, Eighth Circuit

APPENDIX E

STATUTES AND REGULATIONS

1. Section 1341 of Title 18, United States Code, states follows:

§ 1341. Frauds and swindles

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article, for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or deposits or causes to be deposited any matter or thing whatever to be sent or delivered by any private or commercial interstate carrier, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail or such carrier according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined under this title or imprisoned not more than five years, or both. If the violation affects a financial institution, such person shall be fined not more than $1,000,000 or imprisoned not more than 30 years, or both.

2. Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. 78j, states, in pertinent part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerceor of the mails, or of any facility of any national securities exchange—

* * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

3. Section 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. 78n(e), states:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The [Securities and Exchange] Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

4. Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. 240.10b-5 (1983), provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

5. Rule 14e-3(a) of the Securities and Exchange Commission, 17 C.F.R. 240.14e-3, provides:

Rule 14e-3(a) provides:

(a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive, or manipulative act or practice within the meaning of section 14(e) of the [Securities Exchange] Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

(1) The offering person,

(2) The issuer of the securities sought or to be sought by such tender offer, or

(3) Any officer, director, partner, or employee or any other person acting on behalf of the offering person or such issuer,

to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

(3)

Supreme Court, U.S.
FILED
DEC 30 1996
CLERK

No. 96-842

In The

Supreme Court of the United States

October Term, 1996

UNITED STATES OF AMERICA,

Petitioner,

v.

JAMES HERMAN O'HAGAN,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

RESPONDENT'S BRIEF IN OPPOSITION

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15 pp

TABLE OF CONTENTS

Page

STATEMENT OF THE CASE 1

Statement of Facts 1

The Opinion of the Court of Appeals 8

A. Misappropriation Theory 8

B. Rule 14e-3 11

C. Mail Fraud Counts 12

REASONS WHY THE WRIT SHOULD BE DENIED 13

I. The government's Petition misrepresents the record, and, accordingly, the issues for which the government seeks certiorari are not actually presented in this case 13

II. There is no conflict among the circuit courts that have considered the misappropriation theory post-*Central Bank* 15

III. Given its uncertain legal status, the misappropriation theory should not be applied in a criminal context 20

IV. The conflict in the circuits alleged by the government to exist with respect to the validity of Rule 14e-3(a) ignores the impact of *Central Bank* 23

Contents

Page

V. The Court of Appeal's reversal of respondent's conviction for mail fraud creates no conflict with any decision of this Court or any court of appeals and raises no issue of public importance. 30

CONCLUSION 30

TABLE OF CITATIONS

Cases Cited:

Buckley v. Valeo, 424 U.S. 1 (1976) 23

Carpenter v. United States, 484 U.S. 19 (1987) 31

Central Bank v. First Interstate Bank, ___ U.S. ___, 114 S. Ct. 1439 (1994) ..... *passim*

Chiarella v. United States, 445 U.S. 222 (1980) 10, 18, 20, 24, 26

Dirks v. SEC, 463 U.S. 646 (1983) 10, 18, 20

Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) 20

Grayned v. City of Rockford, 408 U.S. 104 (1972) 24

Hynes v. Oradell, 425 U.S. 610 (1976) 23

Citations

Page

O'Connor & Associate v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179 (S.D.N.Y. 1981) 30

Piper v. Chris-Craft Industries, Inc., 430 U.S. 1, 97 S. Ct. 926, 51 L. Ed. 2d 124 (1977) 26, 29, 30

Rondeau v. Mosinee Paper Corp., 422 U.S. 49 (1975) 30

SEC v. Maio, 51 F.3d 623 (7th Cir. 1995) 24

Santa Fe Industrial v. Green, 430 U.S. 462 (1977) 9

Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 105 S. Ct. 2458, 86 L. Ed. 2d 1 (1985) 12, 26, 29

United States v. Bryan, 58 F.3d 933 (4th Cir. 1995) 10, 20

United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) 26, 27, 28

United States v. Kozminski, 487 U.S. 931 (1988) 24

United States v. O'Hagan, 92 F.3d 612 (8th Cir. 1996) ..... *passim*

Viereck v. United States, 318 U.S. 236 (1943) 23

Citations

Page

Federal Statutes Cited

15 U.S.C. §78j(b) 7

15 U.S.C. §78n(e) 7, 25

18 U.S.C. §1341 1

APPENDIX

Appendix A -- Partial transcript of proceedings had before the Honorable James M. Rosenbaum; testimony of Thomas Tinham dated January 25, 1994 ..... 1a

STATEMENT OF THE CASE

Statement of Facts

The government's Petition misstates a fundamental fact in the underlying action. This misstatement of the record is important to this Court's decision whether to grant a writ of certiorari here because the variance between the government's misstatement, on the one hand, and the established facts of record, on the other hand, means that the issue for which the government seeks certiorari is not actually presented in this case. The facts of record are as follows.

The indictment against respondent contained 57 counts, including 17 counts of securities fraud in violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 17 counts of fraud in connection with a tender offer in violation of Section 14(e) of the Exchange Act, and 20 counts of mail fraud in violation of 18 U.S.C. §1341. All 57 counts of the indictment were based on a single predicate act -- the purchase by respondent of Pillsbury stock and call options during a period in which Pillsbury was widely and publicly reported to be a takeover target.

The gravamen of the government's case is that respondent traded in Pillsbury stock and call options on the basis of material, non-public information which he obtained from his former law firm, Dorsey & Whitney ("Dorsey"), in violation of the securities laws. The crucial factual predicate of the government's case, repeatedly asserted during trial, is that respondent's investment in Pillsbury arose after he learned, during a conversation with a law partner on or slightly before August 26, 1988, of "the secret plans" of Grand Metropolitan PLC ("Grand Met") for a Pillsbury takeover. As more fully explained at pages 5 through 7 of this brief, there is simply no evidence to support this essential element of the government's case, and, in fact, the trial judge concluded that the record is directly contrary to the government's contention on this pivotal issue.

In 1987, Grand Met, a British company based in London, England, decided to "refocus" its business by (1) selling its large hotel subsidiary (InterContinental Hotels), and (2) acquiring a "branded food company" in the United States. (Vol. X, p.3).[1] According to the testimony of the then-chief financial officer of Grand Met, as of September 18, 1988, "a decision had been made in principle that we would like to acquire Pillsbury. However, the decision to launch the hostile tender offer had not been taken." (Vol. IX, p. 21) (emphasis supplied). A prerequisite to any takeover bid for Pillsbury was the sale by Grand Met of its hotel business. (Vol. X, pp. 3, 5,8). According to its then-chief financial officer, the Grand Met board required a signed contract for the sale of the hotel subsidiary before any tender offer for Pillsbury could be considered. (Vol. X, p. 23). After difficult negotiations, a contract for the sale of the hotel subsidiary was finally signed on September 30, 1988. (Vol. X, p. 17) Thereafter, the Grand Met board met on October 3, 1988, and authorized a hostile tender offer for the Pillsbury Company.

Respondent is a former attorney who invested in Pillsbury stock and call options that appreciated in value when Grand Met acquired Pillsbury. The government's theory of the case is that -- despite the fact that respondent began investing in Pillsbury in July, 1988, based on solicitations from his brokers -- respondent's investments dated after August 26, 1988, were completed while respondent was in possession of material, non-public information that he learned while a partner at the Dorsey law firm. The government alleges that by purchasing Pillsbury stock and call options, respondent breached a fiduciary duty to the Dorsey firm and to Dorsey's client, Grand Met, in violation of the securities laws.

The sole basis for the government's claim that respondent traded in Pillsbury securities on the basis of material, non-public

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[1] References herein to "Vol ___" are to the trial transcript in this case.

information is a single conversation which took place between Dorsey partner Thomas Tinkham and respondent on, or slightly before, August 26, 1988, concerning the Dorsey firm's representation of an undisclosed client of the law firm of Cravath, Swaine & Moore ("Cravath") in connection with a possible acquisition of the Pillsbury Company. The representation came about as a result of a telephone call placed on July 19, 1988 by a partner of Cravath to Peter Dorsey, a partner at the Dorsey firm, asking the Dorsey firm to act as local counsel for a Cravath client that was considering acquiring Pillsbury. (Vol. IV, p. 34).[2] Peter Dorsey accepted the representation and asked Tinkham to handle the matter.

Tinkham decided to keep the representation of Cravath's client secret, within the Dorsey firm, and thus never opened a "takeover file." (Vol. V., p. 118). Rather, he opened a file on August 4, 1988, entitled "Cravath, Re: General." (Gov. Ex. 56). There was no mention of Cravath's client or of Pillsbury in the file documents and the legal work to be performed was described as general legal work for Cravath. (Vol. V., pp. 58-59). According to the Managing Partner of the Dorsey firm, Robert Struyk, because Tinkham failed to notify Dorsey's bookkeeping department of the nature of the firm's representation of the Cravath client, any member of the firm was free to trade in Pillsbury securities in July through September 1988. (Vol. V., p. 63).[3] The Dorsey firm withdrew from this representation on September 9, 1988, and did not represent Grand Met in its takeover bid for Pillsbury which commenced on October 4, 1988. (Vol. IV, p. 60).

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[2] The transcript of respondent's trial containing the entirety of Tinkham's testimony is included in the Appendix of Respondent ("Resp. App.").

[3] Because of the Dorsey firm's size (320 lawyers) and client base, the firm controlled the trading of securities of its members through its bookkeeping department. As a general matter, when a file was opened, information about the parties involved was provided to bookkeeping. The members of the Dorsey firm were required to check with bookkeeping before trading in any securities. The information available to bookkeeping was provided at the time a file was opened. (Vol. V., p. 62).

Respondent was very active in the stock market and on August 1, 1988, held positions in listed securities with a value of approximately $5 million. Respondent first began investing in Pillsbury on July 27, 1988, when a broker, based on takeover rumors, solicited respondent for a 5,000-share purchase of Pillsbury stock for a total of approximately $180,000. (Vol. VIII, pp. 11-12). Thereafter, on August 18, 1988, another foreign institutional broker advised respondent that he had received a $9 million order to purchase 250,000 shares of Pillsbury at the market from a London, England account. (Vol. VI, p. 34). Beginning that day, respondent started on his goal of purchasing 2,500 Pillsbury options. While one order for 5,000 shares of Pillsbury stock was confirmed on September 20, 1988 (Vol. VI, p.74), the other orders placed by respondent for Pillsbury stock or call options were placed prior to August 26, 1988 -- the date on which the government alleges respondent acquired the material, non-public information which gives rise to its claims of securities fraud [4]

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[4] The government asserts at page 5 of its Petition that "[a]fter his discussion with Tinkham, respondent accumulated additional Pillsbury call options, ..." This statement is misleading. The clear implication is that respondent acted to acquire Pillsbury options on the basis of information provided him by Tinkham. But, in fact, orders for the Pillsbury options had been placed by respondent prior to the alleged August 26, 1988 discussion with Tinkham. Although respondent's orders, which were below-the-market limit orders, were not executed until late August or early September, he began ordering significant blocks of options on August 18th and had placed most of his orders for both options and stock on or before August 25th. (See Gov. Ex. 75, pp. 147-49, Vol. VIII, pp. 45-46, 113, 140-41). As the government admitted below, trades prior to August 26, 1988, could not be illegal because respondent had no insider information prior to that date. (Vol. II-a, p. 27). In its brief to the court of appeals, the government essentially conceded the Achilles heel of its argument that respondent traded on the basis of misappropriated material insider information when it admitted that respondent placed the orders for the Pillsbury securities in question prior to the conversation with Tinkham. "Although Tinkham had no way of knowing, O'Hagan had set himself on a course of accumulating an exceptional number of Pillsbury securities." (Emphasis supplied)

At the time of the Tinkham/O'Hagan conversation, Grand Met's designs on Pillsbury were no secret. On August 18, 1988, a financial columnist disclosed Grand Met's interest in Pillsbury on television, and, on that same day, a San Francisco broker advised O'Hagan that he had just completed a 250,000 Pillsbury share buy offer for a London, England client. The Wall Street Journal had reported that Grand Met had put its hotel chain up for auction to raise money for an acquisition and Investment Dealers Digest had announced that Grand Met was selling its hotel chain in order to buy Pillsbury. (Vol. III, pp. 157-58; Vol. VIII, p. 118; Gov. Ex. 57; Vol. III, pp. 141-42).

It was against this backdrop that the discussion between Tinkham and respondent took place. The discussion, lasting no more than five minutes, occurred as Tinkham was preparing to meet with partners from the law firm's corporate department to discuss whether the firm should represent Grand Met in its efforts to take over a local company. Tinkham testified that just prior to this meeting, he had a conversation with respondent "about a general policy relating to [the firm's] non-involvement in hostile takeovers of local companies." (Vol. V., p. 96) (Resp. App. 13a). Tinkham further testified that in this short conversation, respondent said that he "...understood that I was doing work on a takeover of the Pillsbury Company, and that, ahm, I would remember, as he put it, that he hated the Pillsbury Company." (Id.) (Resp. App. 14a). Tinkham testified that respondent indicated he "would be interested in working on this case." (Id.) (Resp. App. 14a).

The government's Petition asserts that "[a]lthough Tinkham declined respondent's offer to work on the case, Tinkham discussed Grand Met's plans to acquire Pillsbury's common stock with respondent." (Petition at 4) (emphasis supplied). This statement is misleading in every respect. The record is undisputed with respect to what respondent actually learned from Tinkham. Construing the

evidence regarding this conversation in the light most favorable to the government, the most that can be said is that respondent learned from Tinkham that Dorsey had been retained to represent an undisclosed client in connection with a possible takeover of Pillsbury. Respondent did not learn that the Dorsey client was Grand Met. (Vol. V, p. 106) (Rep. App. 24a-25a). Moreover, respondent did not learn any details of any takeover plan. At the time of the Tinkham/O'Hagan conversation, there was not yet a takeover plan in place at Grand Met.

The significance of this discrepancy between the government's statement and the actual record is obvious. In denying respondent's motion to dismiss the indictment, the district court found that "an essential element of the offenses" with which respondent was charged was the government's allegation in paragraph 14 of the indictment that respondent "learned his firm was retained by Grand Met to represent them in connection with a tender offer and then purchased Pillsbury stock and call options..." (Report at 14-15) (emphasis supplied). There is no evidence to support this "essential element" of the government's case. After the government rested, the district court acknowledged that the government had failed to prove this part of its claim when the court stated "...the record says he didn't know it was Grand Met's information." (Vol. VII, p. 82) (emphasis supplied).[5]

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[5] The district court's statement prompted the government to rewrite some proposed jury instructions. In connection with the new instructions, the government made the following admissions to the district court: (1) the government had "put forth [no] evidence showing that [O'Hagan] had direct knowledge that Grand Met was the bidder" (Vol. IX, pp. 79-80), and (2) "[T]here's no evidence showing whether he knew who the client was, who the bidder was." (Vol. IX, p. 80) (emphasis supplied) (Vol. X, p. 26). In light of these admissions, respondent contends that the government committed prosecutorial misconduct by stating to the jury in closing argument that "Tinkham's testimony shows that the defendant knew ... Grand Met's plans ..." (Vol. XI, p. 88) (emphasis supplied).

The government also essentially conceded at trial that it had failed to prove that respondent had obtained material information concerning Grand Met's alleged takeover plan from his law firm. Prosecutor Christopher Bebel so admitted after the government rested:

> MR. BEBEL: Well, they were victimized by Mr. O'Hagan taking information and misappropriating it to his own personal benefit. There's no specific evidence as to the manner in which he first obtained the evidence, as to whether it was by conversation or by documentation.

(Vol. VII, p. 85) (emphasis supplied).

Both before the district court and on appeal, respondent argued that the government had failed to produce evidence essential to support the charges included in the indictment, including specifically any evidence that respondent had purchased securities on the basis of "nonpublic, material" information. Respondent also challenged the legal theories under which he was indicted, arguing, inter alia, that Counts 21-37 of the indictment which charged securities fraud under Section 10(b) of the Exchange Act, 15 U.S.C. §78j(b) should be dismissed because the misappropriation theory upon which the government relied was not encompassed within the express language of Section 10(b). Respondent contended that Counts 38-54, which charged him with fraudulent trading in connection with a tender offer under Section 14(e) of the Exchange Act, 15 U.S.C. §78n(e) and SEC Rule 14e-3(a), 17 C.F.R. 240.14e-3(a) should be dismissed because the SEC had exceeded its rulemaking authority in promulgating Rule 14e-3(a).

On August 2, 1996, the court of appeals reversed respondent's convictions on all 57 counts of the indictment. United States v. O'Hagan, 92 F.3d 612 (8th Cir. 1996). The government's subsequent petition for rehearing and suggestion for rehearing en banc

was denied on November 13, 1996, with only one judge voting to grant an en banc hearing. On November 26, 1996, the government filed its petition for writ of certiorari with this Court. On December 11, 1996, the mandate of the court of appeals issued directing the district court to dismiss the indictment.

The Opinion of the Court of Appeals

While not rejecting any of the eight grounds for reversal asserted by respondent, the court of appeals found merit in two arguments in particular and, on the basis of these arguments, reversed respondent's conviction on all counts. First, the court found that neither the statutory language of Section 10(b) of the Exchange Act, nor Supreme Court precedent interpreting it, will support the use of the misappropriation theory, the theory which formed the basis for O'Hagan's Section 10(b) securities fraud convictions. Second, the court held that the Securities and Exchange Commission exceeded its rulemaking authority under section 14(e) of the Exchange Act when it promulgated Rule 14e-3(a), and omitted therefrom the requirement that a breach of a fiduciary duty must be shown in order to violate the rule. Finally, because the mail fraud counts were structured in the O'Hagan indictment so as to hinge on the validity of the securities fraud counts, the court vacated these counts as well. Judge Fagg wrote a single paragraph in dissent in which he acknowledged that the majority's opinion was "carefully analyzed" and "well reasoned," but disagreed with its result. Id

A. Misappropriation Theory.

Respondent's convictions under Section 10(b) were based solely on the misappropriation theory of securities fraud. As explained by the court of appeals, the misappropriation theory extends liability for securities fraud from corporate insiders to include "outsiders who would not ordinarily be deemed fiduciaries of the corporate entities in whose stock they trade." 92 F.3d at 616. Under

this theory, an individual commits securities fraud if he "(1) misappropriates material nonpublic information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock." Id. at 616-17. The focus of the misappropriation theory is on whether "the securities trader breached a fiduciary obligation to the party from whom the material nonpublic information was obtained, notwithstanding whether that party had any connection to, or even an interest in, the securities transaction, and also without concern as to whether a party who did care about the securities transaction was defrauded." Id

In concluding that the misappropriation theory does not constitute a valid basis for imposing liability under Section 10(b), the court of appeals followed the "definitive ruling" of this Court in Central Bank v. First Interstate Bank, ___ U.S. ___, 114 S.Ct. 1439 (1994), that the text of the operative statute is dispositive in determining the scope of conduct regulated. 92 F.3d at 616. Focusing on the language of Section 10(b), the court of appeals noted that the "touchstone" of liability under the statute is a finding of manipulation or deception in connection with the purchase or sale of a security. The misappropriation theory does not require "deception," but instead "permits the imposition of § 10(b) liability based upon the mere breach of a fiduciary duty without a particularized showing of misrepresentation or nondisclosure." Id at 618. This result contravenes the holdings of Santa Fe Indus. v. Green, 430 U.S. 462 (1977), and Central Bank that "the mere breach of a fiduciary obligation, without misrepresentation or nondisclosure, is not deception within the meaning of §10(b)." 92 F.3d at 618.

The court of appeals also noted a second ground for rejecting the misappropriation theory. Although the language of Section 10(b) requires that the fraud alleged be "in connection with the purchase or sale of any security," the misappropriation theory renders nugatory

this requirement, permitting liability "for a breach of duty owed to individuals who are unconnected to and perhaps uninterested in a securities transaction, ..." Id. at 617. This result is inconsistent with Chiarella v. United States, 445 U.S. 222 (1980), Dirks v. SEC, 463 U.S. 646 (1983), and Central Bank, which limit liability under Section 10(b) to situations involving a "breach of duty to parties to the securities transaction or, at the most, to other market participants, such as investors..." 92 F.3d at 619. By "evading the statutorily required nexus" that the fraud be "in connection with the purchase or sale of a security," and, instead, allowing the imposition of Section 10(b) liability even though no market participant was deceived or defrauded, "the misappropriation theory essentially turns §10(b) on its head, 'transforming it from a rule intended to govern and protect relations among market participants' into an expansive 'general fraud-on-the-source theory' which seemingly would apply to an infinite number of trust relationships." Id. (quoting United States v. Bryan, 58 F.3d 933, 950 (4th Cir. 1995)).

In rejecting the misappropriation theory as a basis for imposing Section 10(b) liability, the court of appeals agreed with the Fourth Circuit's decision in Bryan and departed from the conclusions reached by several of its sister circuits that had been reached prior to this Court's decision in Central Bank. However, the court observed "with all due respect to these courts, for the most part, they seem to adopt the misappropriation theory without conducting a rigorous analysis of the text of 10(b) and Supreme Court precedent." 92 F.3d at 621. Finally, the court of appeals focused on the need for certainty and predictability in the securities context and concluded:

> As the Supreme Court has said, the securities industry generally, and §10(b) specifically, is "'an area that demands certainty and predictability'" and "decisions 'made on an ad hoc basis, offering little predictive value' to those who provide services to participants in the securities business'" are to be

> avoided ... The misappropriation theory undermines this interest by permitting liability to be imposed in a wide variety of circumstances involving a breach of fiduciary duty, presumably including a simple employee theft.

Id. at 622.

B. Rule 14e-3(a)

The court of appeals also reversed respondent's conviction for violation of Rule 14e-3, concluding that because the SEC had exceeded its statutory authority under Section 14(e) of the Exchange Act in promulgating Rule 14e-3, respondent's convictions thereunder were invalid. Consistent with Central Bank, the court of appeals began its analysis of Rule 14e-3(a) with the statutory text of Section 14(e). Section 14(e) makes it unlawful for any person to engage in any "fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer." Section 14(e) also authorizes the SEC by rules and regulations to "define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative [for purposes of subdivision (e)]." Promulgated pursuant to the rulemaking authority under Section 14(e), Rule 14e-3 prohibits trading in securities while in possession of material, nonpublic information, "regardless of whether such information was obtained through a breach of fiduciary duty." 92 F.3d at 623.

In his appeal, respondent argued that the SEC exceeded its rulemaking authority when it promulgated Rule 14e-3(a) by "impermissibly redefin[ing] fraud in Rule 14e-3(a) by omitting the requirement that a breach of fiduciary duty must be shown because the term fraud under §14(e) requires a breach of fiduciary duty." Id. at 624. The court of appeals agreed. The court rejected the government's argument that the rulemaking provision of Section 14(e)

is a "broad delegation to the SEC of rulemaking powers and, when properly read, it empowers the SEC" to define fraud in any way it sees fit. Id. The court concluded that the government was mistaken as to "what the plain language of § 14(e) delegates to the SEC," holding that "the enabling provisions simply permit the SEC to 'define' and 'prescribe' 'acts and practices' which meet § 14(e)'s meaning of 'fraudulent.'" Id. at 624-25.

In determining the meaning of the term "fraudulent" under Section 14(e), the court of appeals concluded that "the analytic model created by the Supreme Court's holdings in Schreiber and Chiarella, cases drawing heavily on common law principles, leads to the inescapable conclusion that fraudulent under § 14(e) must be read to include a breach of a fiduciary duty." Id. at 6625. Important to the court of appeals' conclusion were (1) this Court's holding in Chiarella that fraudulent nondisclosure for purposes of Section 10(b) required a breach of fiduciary duty, (2) the fact that "Section 10(b) and Section 14(e) are contained in the same statutory enactment [which is] strong evidence that the terms are to be given the same meaning" (id.), and (3) this Court's holding in Schreiber that the definition of "manipulative" from Section 10(b) should be used to determine the meaning of the same term in Section 14(e). See 472 U.S. at 11 n. 11, 105 S.Ct. at 2464 n. 11. Because Rule 14e-3 redefines fraud to eliminate any requirement of a breach of fiduciary duty, the court of appeals held that, even in light of the strong deference traditionally accorded to administrative rulemaking, the SEC had exceeded its statutory grant of authority in this case. Accordingly, the court reversed respondent's convictions thereunder.

C. Mail Fraud Counts

The court of appeals reversed respondent's conviction for mail fraud because it concluded that "the indictment was structured in such a manner as to premise the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud." 92 F.3d at 627.

The court was careful to point out that it was not holding, as a matter of law, that where both mail fraud and securities fraud counts are brought, they are necessarily interdependent so that the dismissal of one necessarily requires the dismissal of the other. As stated by the court, "The mere fact that "O'Hagan's securities convictions have been reversed does not as a matter of law require that the mail fraud convictions likewise be reversed." Id. However, "because O'Hagan's conduct did not constitute securities fraud ..., there was no fraud upon which to base the mail fraud charges." Id. at 628.

Judge Fagg, in dissent, did not disagree with the court of appeals' finding that, in this particular case, "the indictment was structured in such a manner as to premise the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud." Id. Judge Fagg simply noted that, since he would uphold the securities fraud convictions, he found no basis to reverse the conviction for mail fraud.

REASONS WHY THE WRIT SHOULD BE DENIED

I. The government's Petition misrepresents the record, and, accordingly, the issues for which the government seeks certiorari are not actually presented in this case.

The government asks this Court to decide whether the purchase or sale of a security while in possession of material, nonpublic information constitutes a violation of Rule 10b-5 and Rule 14e-3(a) if the investor breaches a duty to the source of the information, even though no purchaser or seller or a security has been defrauded. That issue is not presented by the facts of this case.

The crucial core of the government's case, repeatedly asserted during trial and on appeal, is that respondent's investment in Pillsbury arose after he learned of "the secret plans of Grand Met." See, e.g., Vol. XI, pp. 82, 88. It is this alleged knowledge of Grand

Met's secret plans that constitutes the material, nonpublic information essential to sustain the government's claims of securities fraud. As discussed above, however, in actuality the record is uncontradicted that respondent had no knowledge of any "secret plans of Grand Met."

First, at the time respondent had his one and only conversation with his law partner Thomas Tinkham, he did not learn that the Dorsey client contemplating a takeover of Pillsbury was Grant Met. Grand Met's name was not mentioned. The district court acknowledged this fact on the record.

Second, at the time of the Tinkham/O'Hagan conversation, Grand Met's designs on Pillsbury were not secret. It had been widely reported in the press that Grand Met had put its hotel subsidiary up for auction to raise money for the acquisition of Pillsbury.

Third, at the time of the Tinkham/O'Hagan conversation, there was not yet a takeover plan in place at Grand Met. It was not until October 3, 1988, weeks after the alleged conversation, and, indeed, weeks after the Dorsey firm had resigned its representation of Grand Met, that the company authorized a hostile takeover bid.

Finally, the Tinkham/O'Hagan conversation occurred after - not before - respondent embarked on his program of acquiring Pillsbury stock and options. The alleged conversation was on or about August 26, 1988. Although some of respondent's below-the-market limit orders were not executed until late August or early September, he began ordering significant blocks of options on August 18th and had placed most of his orders for both options and stock on or before August 25th. As the government admits, trades prior to August 26, 1988, could not be illegal because respondent had no inside information prior to that date. In short, the government's case hinges on proving that respondent began purchasing Pillsbury

securities after learning from Mr. Tinkham "the secret plans of Grand Met." That simply did not happen.

This case does not present the issue of whether a lawyer breaches a duty to his law firm or its client, and thereby violates the federal securities laws, when he uses material, nonpublic information obtained from the client to trade in the securities of the client's takeover target. In consequence, if this Court were to grant certiorari, it would not reach the issue for which the government seeks review without assuming hypothetical facts not presented by, and, indeed, contrary to, the record in this case.

II. There is no conflict among the circuit courts that have considered the misappropriation theory post-Central Bank.

The Central Bank decision, issued in 1994, was widely haled by commentators and legal scholars as a watershed opinion which applied a brake to the government's attempts to regulate in the securities arena beyond the express statutory language enacted by Congress. The legal principles articulated in Central Bank are controlling here with respect to both the misappropriation theory and Rule 14(e). Despite the clear applicability of Central Bank, however, the government's Petition completely ignores this seminal decision, notwithstanding that it was, from the start, a cornerstone of respondent's appeal, referenced repeatedly in respondent's briefing. The reason for the government's studious omission of any reference to Central Bank is clear. The extension of law by judicial legislation which the government seeks cannot be reconciled with Central Bank.

The only two courts of appeals to have considered the misappropriation theory in light of Central Bank -- the Fourth Circuit in Bryan and the Eighth Circuit in the instant case -- have recognized the controlling significance of the case and have unanimously rejected

the theory as inconsistent with the principles articulated therein. There simply is no present conflict in the circuits on this issue.

In Central Bank, this Court reversed years of precedent in the federal courts and held that plaintiffs do not have a private right of action for aiding and abetting violations of Section 10(b). The Court based its decision on the text of Section 10(b), holding that with regard to the scope of conduct covered by Section 10(b), "the text of the statute controls our decisions," and noting that with respect to prior decisions "[w]e have refused to allow 10b-5 challenges to conduct not prohibited by the text of the statute." 114 S.Ct. at 1446 (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977), and Chiarella v. United States, 445 U.S. 222 (1980)). Because the text of Section 10(b) "does not in terms mention aiding and abetting," the Court concluded that there was no cause of action for aiding and abetting. The Court noted in this regard that if Congress intended Section 10(b) to cover aiding and abetting, "we presume it would have used the words 'aid' and 'abet' in the statutory text." Id. at 1448.

While aiding and abetting is not involved in this case, the Court in Central Bank defined the parameters of Section 10(b) in language directly applicable to this case. The Court reiterated its conclusion in that "§10(b) is not violated [when a person trades securities without disclosing inside information] unless the trader has an independent duty of disclosure." Id. In this regard, the Court emphasized that "not every instance of financial unfairness constitutes fraudulent activity under §10(b)" and that, while "Section 10(b) is aptly described as a catchall provision, ... what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak." Id. Finally, while the Court in Central Bank expressed its view that, in certain instances, aiding and abetting a wrongdoer ought to be actionable, it noted that the issue before it was "not whether imposing private civil liability on aiders and abettors is good policy but whether aiding and abetting is

covered by the statute." Id. Reiterating that Section 10(b) prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act, and says nothing about giving aid to a person who commits a manipulative or deceptive act, the Court concluded:

> When a statute speaks so specifically in terms of manipulation and deception ..., we are quite unwilling to extend the scope of the statute. ... We cannot amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute.

Id.

Central Bank builds upon, and is consistent with, the Court's prior decisions in Chiarella and Dirks, supra, both of which are here applicable. In Chiarella, the government, conceding that it was urging a novel application of Section 10(b), prosecuted an employee of a financial printer who deciphered the identities of targets of upcoming takeover bids from documents he received for printing. Chiarella was convicted at trial and his conviction was affirmed by a divided panel of the Second Circuit. The Supreme Court reversed Chiarella's conviction because Chiarella, an outsider, had not engaged in any conduct that could constitute criminal fraud under Section 10(b) or Rule 10b-5. Id. at 235. The Court explained that "there can be no fraud absent a duty to speak," and while Chiarella's conduct may have been "unfair," he did not violate Section 10(b) because he was an outsider who owed no duty to "speak" to the shareholders. Id.

The holding of Chiarella was confirmed in Dirks where the Court rejected a parity-of-information rule in setting the standards for "tippee" liability. Dirks stands for the proposition that a violation of Rule 10b-5 must include a breach of duty to the shareholders of the target corporation, and if the accused is not an insider, his conduct

must be traced back to an insider such that he has adopted the insider's duties

Taken together, Central Bank, Chiarella, and Dirks hold that Rule 10b-5 challenges are not allowed as to conduct not prohibited by the text of Section 10(b), that the deception proscribed in Section 10(b) is the making of a material misrepresentation or the nondisclosure of material information in violation of a duty to disclose; and that the deception to which the statute is directed is deception of purchasers and sellers of securities. As the court of appeals found in this case, the misappropriation theory upon which the government relies cannot survive the Supreme Court's analysis in Central Bank, Chiarella and Dirks because it expands the scope of Section 10(b)'s prohibition against "fraud" beyond the statutory text to allow for a violation without any showing of deception in breach of a duty to purchasers or sellers of the traded securities.

The government takes issue with the court of appeal's reasoning, contending that it erred in holding that the misappropriation theory does not require a showing of deception and arguing that, in any event, there was evidence of deception in this case. The government contends that respondent engaged in deception by "us[ing] his privileged position of trust and confidence to exploit [his] principal's confidential information for personal gain." (Petition at 13). Wholly apart from the obvious misstatement of facts (there is no evidence that respondent obtained any "confidential information" during his conversation with Tinkham and the record indicates that, consistent with the policy of his law firm, respondent was free to trade in Pillsbury securities at the time of the alleged conversation), deception alleged by the government does not fall with the proscription of Section 10(b). As the court of appeals recognized, and as is clear from both the Chiarella and Dirks opinions, for there to be a violation of Section 10(b) or Rule 10b-5, there must be a breach of duty between the parties to the securities transaction. See 92 F.3d at 619. Respondent owed no duty to Pillsbury's shareholders

and did not misrepresent anything to them. Accordingly, there was no deception within the meaning of Section 10(b).

The government also contends that the court of appeals erred in concluding that fraud cannot be "in connection with" the purchase or sale of securities and, therefore, cannot give rise to Section 10(b) liability, where no market participant was deceived or defrauded. The government contends that it is enough to satisfy the "in connection with" requirement that the misappropriator be shown to have traded in securities while in possession of material, non-public information.

As the court of appeals noted in rejecting this argument, however, to accept the government's position would "essentially turn[] §10(b) on its head, 'transforming it from a rule intended to govern and protect relations among market participants' into an expansive 'general fraud-on-the-source theory'." 92 F.3d at 619 (quoting Bryan, 58 F.3d at 950). The court of appeals in Bryan summarized the fallacy in the government's interpretation of Section 10(b) when it noted that the misappropriation theory "artificially divides into two discrete requirements -- a fiduciary breach and a purchase or sale of securities -- the single indivisible requirement of deception upon the purchaser or seller of securities, ..." 58 F.3d at 951.

As noted by the court of appeals in this case, moreover, the government's position cannot be squared with this Court's decisions in Chiarella, Dirks, and Central Bank which reveal that "only a breach of a duty to parties to the securities transaction or, at the most, to other market participants such as investors, will be sufficient to give rise to §10(b) liability." 92 F.3d at 619. See also Chiarella, 445 U.S. at 230 (duty to disclose for purposes of Section 10(b) arises only "from a relationship of trust and confidence *between parties to a transaction*") (emphasis supplied); Dirks, 463 U.S. at 664 n. 23 ("a violation [of §10(b)] may be found only where there is 'intentional or willful conduct designed to deceive or defraud investors'") (quoting

Ernst & Ernst, 425 U.S. at 199); Central Bank, 114 S. Ct. at 1455 ("Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which *a purchaser or seller of securities* relies may be liable as a primary violator under 10b-5...") (emphasis supplied); id. at 1446 (stating that "the broad congressional purpose behind the [Securities] Act" is "to protect *investors* from false and misleading practices that might injure them") (emphasis supplied).[6]

III. Given its uncertain legal status, the misappropriation theory should not be applied in a criminal context.

The government contends that, unless review is granted in this case, it will have been "deprive[d]" of an "important tool" with which to combat securities fraud. (Petition at 11). But, of course, it is Congress, not the courts, which decides what statutory weapons the SEC should have to combat securities fraud. And Congress has expressed doubt as to whether the misappropriation theory, as defined by the government in this case, is encompassed within the express language of Section 10(b).

In November 1988, the Insider Trading and Securities Fraud Enforcement Act of 1988 was signed into law. That legislation, enacted after the conduct here at issue allegedly occurred, created a private cause of action for misappropriation. Reflecting on the state

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[6] As a fall-back position, the government suggests here as it did in the court of appeals below that, even if the "in connection with" element of Section 10(b) were construed to require "fraud on market participants," that element is satisfied here because Grand Met was "poised to become a market participant." (Petition at 14). At the time of the alleged deception, Grand Met was obviously not a market participant, having not yet decided to commence a tender offer, a fact which the government does not dispute. The government cites no authority -- and respondent is aware of none -- which would suggest that fraud on a potential future market participant is sufficient to satisfy the "in connection with" requirement of Section 10(b).

of the law prior to the new legislation, Congress analyzed Chiarella and Dirks as follows:

> Despite the breadth of the statutory and regulatory framework for insider trading, several major court cases in recent years have established clear boundaries for prosecution of these violations. In [Chiarella] the Supreme Court held that a duty to disclose under Rule 10b-5 does not arise from the mere possession of nonpublic market information. The Court held that under Rule 10b-5 a duty to disclose only arises from a fiduciary relationship or other relationship of trust and confidence between parties to the transaction. [Emphasis supplied] In the absence of such a relationship, a trader is not liable for injuries or damages suffered by the other party to the transaction who lacked the same information as the trader nor is he subject to criminal sanction, on a theory that the trader's failure to disclose defrauded the other party to the transaction.
>
> The Supreme Court followed a similar narrowing approach in [Dirks].
>
> • • •
>
> The Chiarella and Dirks decisions establish that there is no general duty to disclose material nonpublic information before trading on it.

Report of the House Committee on Energy and Commerce to accompany H.R. 5133, the Insider Trading and Securities Fraud Enforcement Act of 1988, H. Rep. 100-910, 100th Congress, 2d Session 9 (1988), 1988 USCAN 6046 (emphasis supplied). Commenting specifically on the misappropriation theory, the Congressional Report accompanying the 1988 legislation noted that,

although the misappropriation theory "clearly remains valid in the Second Circuit ... [its status] is unresolved nationally." Id. at 6047.

It is thus clear from this legislative history that Congress, which alone has the authority to promulgate federal securities law, did not consider the misappropriation theory to be established law in 1988, contrary to the government's assertion in this case. While the interpretation by a subsequent Congress of a statute enacted by a prior Congress is obviously not controlling, see discussion at note 8, infra, the fact that the branch of government responsible for defining the SEC's authority in the securities field considered the statutory authorization for the misappropriation theory to be uncertain in 1988 is significant. Consistent with the due process clause's fair notice requirement, those accused of criminal conduct are entitled to meaningful notice of the law. See, e.g., Hynes v. Oradell, 425 U.S. 610 (1976) (holding that all are persons entitled to be informed as to what the state commands or forbids, and no one may be required at peril of life, liberty, or property to speculate as to the meaning of penal statutes). Buckley v. Valeo, 424 U.S. 1 (1976) (due process requires that a criminal statute provide adequate notice to a person of ordinary intelligence that his contemplated conduct is illegal). Here, the legal theory under which respondent was prosecuted was so unclear in 1988 that Congress itself expressed doubts as to the theory's existence.

Notwithstanding the doubts expressed by Congress concerning the misappropriation theory's legal roots, the government contends in its Petition, as it has all along, that the misappropriation theory is important to its ability "to ensure the maintenance of honest securities markets." (Petition at 24). As this Court has noted, however, "[t]he issue [for the courts] is not whether imposing ... liability ... is good policy but whether [it] is covered by the statute." Central Bank, 114 S. Ct. at 1448. The misappropriation theory is not referenced expressly in Section 10(b). At the time the conduct here at issue allegedly occurred, no statute creating a cause of action for

misappropriation had been enacted. There is, of course, no federal common law: "[H]owever deserving of punishment ... conduct may seem," the federal courts may punish a defendant only if Congress has specifically defined the criminal conduct and authorized the penalty. Viereck v. U.S., 318 U.S. 236, 243 (1943). Even if this Court were to conclude that an argument for implying such a cause of action in Section 10(b) could be made, there is sufficient uncertainty concerning the validity of the theory to avoid its application in a criminal context. See Grayned v. City of Rockford, 408 U.S. 104, 108 (1972) ("It is a basic principle of due process that an enactment is void for vagueness if its prohibitions are not clearly defined."); United States v. Kozminski, 487 U.S. 931, 951 (1988) (the Constitution does not "tolerate the arbitrariness and unfairness of a legal system in which the judges would develop the standards for imposing criminal punishment on a case-by-case basis"). As this Court warned in Chiarella, "a judicial holding that certain undefined activities 'generally are prohibited by §10(b) would raise questions whether either criminal or civil defendants would be given fair notice that they have engaged in illegal activity.'" 445 U.S. at 235, n.20.

IV. The conflict in the circuits alleged by the government to exist with respect to the validity of Rule 14e-3(a) ignores the impact of Central Bank.

The government argues that the Court must review this case because there is "a conflict among the courts of appeals" regarding the validity of Rule 14e-3(a) (Petition at 19). Although the government is correct that, until the lower court's decision in this case, "all [three] courts of appeals that had addressed the issue had found Rule 14e-3(a) to be valid" (id.), it fails to state that not a single other appellate court had analyzed Rule 14e-3(a) in light of this Court's seminal decision in Central Bank.*

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* Indeed, only one other court of appeals has had the opportunity to consider Rule 14e-3(a) since Central Bank. However, the Seventh Circuit, in SEC v. Maio,

The government contends that the court of appeals erred in holding that the SEC exceeded its rulemaking authority when it promulgated Rule 14e-3(a) without including a requirement of a breach of fiduciary obligation; the government's objection to the lower court's holding is based on its argument that the SEC has been granted broad rulemaking authority by Section 14(e), and that rules promulgated under Section 14(e) have legislative effect and are, thus, entitled to great deference. Taking the government's argument to its logical end, however, would extend the SEC's rulemaking authority beyond the language of the statute on which it rests. As the court of appeals recognized, this argument is wholly inconsistent with this Court's holding in Central Bank that the text of the underlying statute controls in assessing the validity of an administrative rule, notwithstanding any policy-based reason advanced by the agency for extending its authority beyond that granted by the statute. Central Bank, 114 S. Ct. at 1448 ("The issue ... is not whether imposing liability [for such conduct] ... is good policy, but whether [the conduct] is covered by the statute.") An administrative rule that exceeds, or is inconsistent with, its statutory mandate is invalid. Thus, in this case, the validity of Rule 14e-3(a) ultimately turns on the plain language of Section 14(e).

The text of Section 14(e) prohibits fraud in connection with a tender offer. When subdivision (e) was added to Section 14 in 1968, it provided that:

> It shall be unlawful for any person to make an untrue statement of material fact or omit to state any material fact necessary in order to make the statement made, in light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation.

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51 F.3d 623 (7th Cir. 1995), appears not to have considered Central Bank in upholding Rule 14e-3(a). There is no mention of the case in the court's opinion.

15 U.S.C. § 78n(e). This provision was enacted as part of the Williams Act. "'The purpose of the Williams Act is to insure that public shareholders who are confronted by a cash tender offer for their stock will not be required to respond without adequate information.'" Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 8, 105 S.Ct. 2458, 2462, 86 L.Ed.2d 1 (1985); see also Piper v. Chris-Craft Indus., 430 U.S. 1, 35, 97 S.Ct. 926, 946, 51 L.Ed.2d 124 (1977) ("The legislative history thus shows that the sole purpose of the Williams Act was the protection of investors who are confronted with a tender offer.") In particular, the purpose of Section 14(e) was to "add[ ] a broad antifraud prohibition modeled on the antifraud provisions of § 10(b) ... and Rule 10b-5...." Schreiber, 472 U.S. at 10, 105 S.Ct. at 2463. In 1970, Congress added language to subdivision (e) which required that the SEC "by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative [for purposes of subdivision (e)]." Id.

In 1980, the SEC promulgated Rule 14e-3, which imposes liability for insider trading in the absence of any breach of duty. The government argues that in promulgating Rule 14e-3, the SEC was "well within its authority to define a specific act or practice as fraudulent in the tender offer setting without requiring 'the breach of fiduciary obligation or similar trust relationship'" (Petition at 18). By disposing of the requirement of breach of duty, however, the SEC exceeded its rulemaking authority because it created law beyond the text of Section 14(e). The text of the statute prohibits "fraudulent, deceptive, or manipulative acts." As explained by the Supreme Court in Chiarella, one who fails to disclose material information prior to

consummation of a transaction does not commit a "fraudulent act" unless one breaches a duty to disclose arising out of a "fiduciary or other similar relation of trust and confidence." 445 U.S. at 228. By reinventing the definition of "fraudulent act," the SEC made law beyond that dictated by the statute.

In support of its position, the government relies primarily on the Second Circuit's decision in United States v. Chestman, 947 F.2d 551 (2d Cir. 1991), a case decided before Central Bank. In Chestman, the court of appeals upheld Rule 14e-3 based on the rulemaking provision that Congress added to Section 14(e) in 1970 which authorizes the SEC to "define, and prescribe means reasonably designed to prevent such acts as are fraudulent, deceptive, and manipulative." The Chestman court interpreted this provision to mean that the SEC could by rule redefine fraud, even if the rule contravenes the definition of fraud established by this Court in Chiarella; the court held instead that all that was necessary is that the rule retain "a close nexus between the prohibited conduct and the statutory aims."[6] Id. at 560. Central Bank makes Chestman's

[6] In upholding Rule 14e-3, the Chestman court also pointed to subsequent Congressional enactments such as the Insider Trading Sanctions Act of 1984, and the Insider Trading and Securities Act of 1988 -- in which Congress did not make any substantive changes to the law -- as congressional support for the status quo. Finally, Chestman distinguished Chiarella on the ground that the latter case involved Section 10(b) -- not Section 14(e). In finding no aider and abettor liability under Section 10(b), however, this Court in Central Bank rejected arguments identical to the stated bases for the Chestman court's holding. First, as noted above, Central Bank made clear that the substantive text of the statute determines the scope of prohibited conduct. Second, in relying on the rulemaking provision in Section 14(e), which was added in 1970, rather than the substantive provision in Section 14(e), which was enacted in 1968, Chestman relied on a subsequent Congress to determine the intent of the 1968 Congress. This too is impermissible under Central Bank. "[T]he interpretation given by one Congress (or committee or Member thereof) to an earlier statute is of little assistance in discerning the meaning of that statute." 114 S.Ct. at 1452. With regard to Chestman's reliance on Congress' purported acquiescence, the same argument was made by the government and rejected by the Court in Central Bank. Id. at 1453

holding untenable, because, as this Court explained, the scope of the conduct prohibited by the securities laws is defined by the express language of the statute and, accordingly, for an agency's rulemaking to be valid, more is required than a mere "nexus" between the rule and the statute.

To accept the government's argument that the rulemaking provision in Section 14(e) permits the SEC to redefine "fraudulent practices" to exclude the requirement of a breach of duty to disclose would mean that the prohibited conduct would no longer be determined by the substantive text of the statute. This is impermissible under Central Bank. The rulemaking language of Section 14(e) permits the SEC only to "define" and "prescribe" "acts and practices" meeting the statutory definition of "fraudulent." See Chestman, 947 F.2d at 584 (Mahoney, J., concurring in part and dissenting in part) ("[T]he plain meaning of the dispositive language is that the SEC is empowered to identify and regulate, in this (then) novel [tender offer] context, the 'acts and practices' that fit within the existing legal categories of the 'fraudulent, deceptive, or manipulative,' but not to redefine the categories themselves.").

The government urges a much broader reading of the second sentence of Section 14(e), arguing that the plain language is a broad delegation to the SEC of rulemaking powers and that it gives the SEC full authority to "define" and "prescribe means reasonably designed to

(cautioning that the Court's past discussions of the dubious "acquiescence doctrine indicate its limitations as an expression of congressional intent").

Finally, the Chestman court concluded that Supreme Court cases interpreting fraud under Section 10(b) are not applicable in assessing the SEC's rulemaking authority under Section 14(e). Central Bank, however, makes clear that adherence to the statutory text applies to all sections of the 1934 Act. Although Central Bank dealt with scope of conduct prohibited by Section 10(b), the Court stated unequivocally that its textual analysis applied to all provisions in the Securities Act. See Central Bank, 114 S.Ct. at 1447 ("Adherence to the text in defining the conduct covered by § 10(b) is consistent with our decisions interpreting other provisions of the securities Acts.").

prevent" "fraudulent conduct" in the tender offer context. (Petition at 18). As the court below recognized, however, "the government conflates the language of the statute into a broad empowerment to the SEC to 'define' and 'prescribe' 'fraud'.... [T]his is not what the plain language of § 14(e) delegates to the SEC; the enabling provisions simply permit the SEC to 'define' and 'prescribe' 'acts and practices' which meet § 14(e)'s meaning of 'fraudulent.'" 92 F.3d at 625. And, because this Court in Chiarella has already defined "fraudulent nondisclosure" under the securities laws,[9] any attempt by the SEC to redefine the term to eliminate an essential component renders the SEC's action invalid.

Because the court below is the only court of appeals to analyze Rule 14e-3 in light of Central Bank, the issue of whether the Rule survives Central Bank is not yet suitable for review by this Court. Moreover, the fact that only four courts of appeal have had occasion to address the issue of the Rule's validity since its promulgation in 1980 belies the government's contention that the decision of the court below "critically weakens the government's ability to prosecute the misuse of material, nonpublic information in the securities markets." (Petition at 10)

Finally, there is one additional reason why this case is not the proper vehicle for deciding the issue regarding the validity of Rule 14e-3(a) which the government seeks to present. On the facts of this case, one never reaches the issue of Rule 14e-3(a)'s validity because Section 14(e) itself has no applicability. Violations of Section 14(e) cannot occur unless and until a tender offer is made. At the time respondent is alleged to have traded in Pillsbury stock and options,

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[9] In Schreiber, the Court explicitly held that Section 14(e) is modeled after the broad antifraud provisions of s 10(b) and Rule 10b-5. 472 U.S. at 10 & n. 10. Accordingly, the term "fraudulent" should be interpreted consistently for both Section 10(b) and Section 14(e). See id. at 7-8 & n. 6 (using Section 10(b)'s definition of the term "manipulation" to define the same term under Section 14(e)).

there was no tender offer. Respondent's last "purchase" of any Pillsbury securities occurred on September 21, 1988; the tender offer was not made until October 4, 1988.

In arguing that Section 14(e) may be violated prior to the announcement of a tender offer, the government again ignores the plain language of the statute which regulates fraudulent practices in connection with a tender offer. In Piper v. Chris-Craft Industries, Inc., 430 U.S. 1 (1977), this Court, after an exhaustive review of the legislative origins of Section 14(e) concluded:

> [T]he sole purpose of the Williams Act [which included the first sentence in Section 14(e)] was the protection of investors who are confronted with a tender offer. As we noted in Rondeau [v. Mosinee Paper Corp., 422 U.S. 49 (1975)] ... 'The purpose of the Williams Act is to ensure that public shareholders who are confronted by a cash tender offer for their stock will not be required to respond without adequate information.'

Id. at 35.

Consistent with Piper, Section 14(e) is inapplicable to the instant case because the alleged violations occurred prior to the tender offer. Although Rule 14e-3(a) purports to extend Section 14(e) to include conduct occurring after "any person has taken a substantial step or steps to commence ... a tender offer ...," the substantive text of Section 14(e) does not provide for this extension.[10] And, under

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[10] A challenge to this part of Rule 14e-3 was made in O'Connor & Assoc. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179 (S.D.N.Y. 1981). The district court in that case upheld the Rule, basing its decision on the rulemaking provision which Congress added to Section 14(e) in 1970 which authorizes the SEC to "define and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative." 529 F. Supp. at 1191.

Central Bank, the substantive text of the statute determines the scope of the prohibited conduct.

V. The Court of Appeal's reversal of respondent's conviction for mail fraud creates no conflict with any decision of this Court or any court of appeals and raises no issue of public importance.

The court of appeals reversed respondent's conviction for mail fraud because it concluded that "the indictment was structured in such a manner as to premise the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud." 92 F.3d at 628. Thus, because the government had failed to establish securities fraud, there was no fraud upon which to base the mail fraud charges. Id.

In reversing the mail fraud conviction, the court of appeals was careful to point out that it was not holding, as a matter of law, that where both mail fraud and securities fraud counts are brought, they are necessarily interdependent so that the dismissal of one necessarily requires the dismissal of the other. Id. at 627. The conflict which the government seeks to create between this case and Carpenter v. United States, 484 U.S. 19 (1987), in this regard simply does not exist. The court of appeal's ruling with respect to the mail fraud counts was fact specific and raises no issue of any importance beyond this case. Accordingly, review by this Court is not warranted.

CONCLUSION

For the reasons set forth above, the petition for a writ of certiorari should be denied.

Central Bank, however, makes it clear that the substantive text of the statute determines the scope of the prohibited conduct. Because the substantive text of Section 14(e) does not provide "If any person has taken a substantial step or steps ...," the holding in O'Connor contravenes Central Bank.

Respectfully submitted.

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APPENDIX A — PARTIAL TRANSCRIPT OF PROCEEDINGS HAD BEFORE THE HONORABLE JAMES M. ROSENBAUM, TESTIMONY OF THOMAS TINKHAM DATED JANUARY 25, 1994

[Commencing at page 1]

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
FOURTH DIVISION

Criminal No. 4-92-219

Volume V

January 25, 1994

United States of America,

Plaintiff,

-v-

James Herman O'Hagan,

Defendant.

TRANSCRIPT OF PROCEEDINGS

HAD BEFORE THE HONORABLE

JAMES M. ROSENBAUM, and a Jury

Minneapolis, Minnesota

APPEARANCES:
For the Government — Christopher Bebel, Jon Hopeman

For the Defendant — Charles Hawkins

* * *

[85] A. Umm, well, generally my administrative matters were not billed.

Q. And is it fair to say that when you're talking about what you've talked about here, I believe your term was discussing issues that are in the best interests of the client; do you recall that phrase?

A. Yes.

Q. Not in the best interests of the law firm, correct?

A. That's correct.

MR. HAWKINS: I have no further questions, Your Honor.

MR. BEBEL: We have nothing further.

THE COURT: You may step down, Mr. Struyk. Thank you.

MR. BEBEL: We call Tom Tinkham.

THE COURT: Sir, would you step forward, please. Would you raise your right hand.

(Witness sworn.)

THE COURT: Would you please be seated. Please state your name, and spell your last name.

THE WITNESS: My name is Tom Tinkham, spelled T-I-N-K-H-A-M.

DIRECT EXAMINATION

(Thomas Tinkham)

BY MR. BEBEL:

[86] Q. Mr. Tinkham, why don't you tell us about your educational and professional background.

A. I went to college at the University of Wisconsin at Madison. I graduated in 1966. I went to Harvard Law School and graduated in 1969. I came to Minneapolis to practice law, and joined the firm, ah, that is now known as Dorsey and Whitney in 1969. For a period of a year or so I left Dorsey and Whitney and became the Hennepin County public defender, representing people in Hennepin County who were charged with crimes on an indigent basis, and I have been at Dorsey and Whitney without exception since then, and I've been there about 24 years practicing civil trial law.

THE COURT: Can you pull slightly closer to the microphone if you would, Mr. Tinkham.

BY MR. BEBEL:

Q. And you're a partner in the firm?

A. I am.

Q. And you've been a partner for approximately how many years?

A. Nineteen.

Q. And have you held any positions within the firm? If so, tell us about them.

A. Yes, I have. I have been on a number of committees in the firm, including the recruiting committee, the finance committee, the professional personnel committee, the partner [87] review committee, and, ah, I was chairman of the trial department, the litigation department at Dorsey and Whitney for three years, or three and a half years during the period '86 through '89, and I'm currently responsible at Dorsey and Whitney for the quality of practice, including issues about how we practice law, what we do in particular situations, claims made against the firm, ah, and work with various lawyers in those kinds of settings.

Q. And what types of legal related positions have you held outside the firm?

A. Ahm, numerous of them. Ah, most significantly would be in the bar association, which is an organization of lawyers, I've been president of the Hennepin County Bar Association, and president of the Minnesota State Bar Association, which is composed of about 12,000 member lawyers.

Q. Okay. Let's go to 1988. During 1988 did the law firm of Cravath, Swain, and Moore contact the Dorsey and Whitney law firm?

A. Yes.

Q. And when did you first learn that this contact had been made and tell us what the nature of the contact was, also.

A. I learned of it sometime in mid July of 1988 in a conversation with, ah, Peter Dorsey and Bob Struyk, which they told me that the firm had been contacted by a man by the name of Alan Maulsby at Cravath, and asked if we were [88] interested in participating in some work that they were involved in.

Q. And then did the — did you later learn who this work — well, let me rephrase that. Was a file opened up after this contact was made?

A. Yes.

Q. And the name Cravath was put on the file?

A. Correct.

Q. And did you speak with any Cravath attorneys yourself?

A. Ah, yes.

Q. Okay. What Cravath attorney, or —

A. I believe his name was Alan Parker.

Q. And how soon after this contact had been made did you begin speaking with Alan Parker?

A. By late July of 1988.

Q. And by that time, had you been advised as to what the nature of the services were that you were being asked to provide?

A. Yes.

Q. And what was your understanding as to the nature of those services?

A. There was a company by the name of Grand Met, ah, that was, ah, primarily an English company that was interested in acquiring all of the stock of Pillsbury Company in Minneapolis. And in connection with that, the people at [89] Grand Met would need to know a good deal about the law of the state of Minnesota as it applied to an acquisition like that. And they might also need some assistance in, umm, litigation or trial work in the event that there was litigation or trials of that kind in Minnesota involving a dispute that might develop over this proposed acquisition.

In addition, as it developed, they were also interested in, umm, whether or not Dorsey and Whitney could provide some services along the lines of introducing the people at Grand Met to various officials at the state and the county and so on.

Q. And this acquisition was to be brought about through what?

A. The acquisition was to be brought about, as I understood it, by the purchase of stock, a stock offering.

Q. A tender offer?

A. I think that's an apt — that's a word I'd use, yes.

Q. And as for these services that your law firm was to provide, who was to head up that representation?

A. Well, at least with regard to, ah, anything having to do with trial and litigation, I was.

Q. Now, after this business had been brought into the firm, did any tension or disagreement develop as to whether or not the firm should be doing this kind of work?

A. Yes, Yes, it did.

[90] Q. Okay.

A. Although, let me just say that the tension was there and preexisted this to some extent, with regard to this type of representation.

Q. And so then how soon does this tension start focusing on this representation after the business is brought in?

A. Well, within, ah, some relatively short time after I became aware of this possible representation, I also became aware that it was the desire of Bob Struyk to make sure that the corporate department was comfortable with this, and to meet with them and talk with them about that. And I then became aware that some of the people in the corporate department weren't comfortable with this.

Q. Were not?

A. Were not.

Q. And, on the other hand, people in the litigation department, what was their belief?

A. Well, generally people in the litigation department had discussed this kind of possibility before and thought that it was something that we could and should do.

Q. So you have two opposing viewpoints within the firm, generally speaking?

A. Yes, we did.

Q. And were those opposing viewpoints discussed at any meetings?

[91] A. Yes, they were.

Q. Let's go to the first meeting. Do you recall when that was held?

A. Well, I recall when it was, because I've checked my calendar a good number of times with regard to it. It was on the 26th of August of 1988.

Q. And showing you Government's Exhibit 57, is this your calendar that you were talking about?

A. It is.

MR. BEBEL: And we move that Government 57 be admitted.

MR. HAWKINS: May I also ask a couple of additional foundation questions at this time?

THE COURT: Certainly.

BY MR. BEBEL:

Q. Now, you see on Government's Exhibit 57, that there's really only one entry. Can you explain for us why there is only one entry and what brought that about?

A. Certainly. This, ah, particular document is a photocopy of a calendar that I used to keep on my desk. It's the type that sits on your desk, and it's about two feet wide and a foot and a half high. And, umm, I would then fill in each day meetings I had or appointments or court dates or meetings with clients, whatever it would be. This covers a period, August of '86, and as a part of not revealing [92] information about other clients, when I produced this to the government, I excluded from it other dates and other references to other matters, that is other client matters other than this particular one, the Grand Met one.

Q. Okay. Just to help us out a little bit, why did you not want to review matters relating to other clients?

THE COURT: I think I just thought — it only concerned other cases and other issues.

MR. BEBEL: Okay. And we once again move that the exhibit be admitted into evidence.

MR. HAWKINS: May I —

BY MR. HAWKINS:

Q. Does this represent your calendar for the entire month of August as it relates to anything to do with Grand Met?

A. Well, that was the intent of doing it this way. I can't, without going back and actually looking at it, I can't tell you that to a hundred percent certainty.

Q. But to the best of your recollection, that would reflect the only entry you've made in the entire month of August relating, or that was relevant to this case?

A. You know, I don't have an independent memory of that before I'd check again.

MR. BEBEL: Your Honor, I'd move it would be provisionally admitted.

MR. HAWKINS: I don't have objection to that.

[93] THE COURT: It's admitted under all circumstances by agreement.

BY MR. BEBEL:

Q. Okay. And the document reflects that what happened on the 26th of August?

A. Well, my calendar reflects that I had a meeting with Robert Struyk, et al, that morning.

Q. Okay. And that entry on your calendar, does that relate to the meeting where this tension that developed within the firm was discussed?

A. It does.

Q. And can you give us your best recollection as to who attended that meeting?

A. Well, I know I was there, and I know Bob Struyk was there, and I recall that two people from the corporate department by the names of, umm, Rich Swanson and Lee Mitou were there. It may be that Peter Dorsey or Warren Spannaus were there for a time, but as I sit here, I don't remember them being there specifically.

Q. And generally, what was discussed and what was decided?

A. What was discussed was the pros and cons of representing someone who was going to acquire a substantial local company. The people, Rick Swanson, and Lee Mitou, took the position that it was inadvisable, it was wrong, inappropriate for us to do so because many of our clients [94] who were in similar situations, that is they were corporations in Minneapolis, who would be unhappy with our representing somebody who was kind of acting in a threatening way to another corporation, that was local.

I took the position, and I think Bob Struyk agreed with me, that in this situation, ah, this was ordinary, normal legal work that we were being asked to do. Umm, that, ah, as long as what we were being asked to do was substantial legal work, ah, of a

kind regularly done, it should be something that we could do and our clients ought to perceive it as appropriate.

We recognized a tension and a disagreement existed. It wasn't resolved, except that we decided we would go forward with the representation but continue to monitor it to insure that in fact we were doing substantial legal work.

Q. Bottom line, you decided to stay with the case for the time being?

A. Correct.

Q. And prior to this August 26 meeting, were you giving any thought to what your position would be at the meeting?

A. I — I was.

Q. And during the period before the meeting, did you receive James O'Hagan as a visitor at your office?

A. I did.

Q. And approximately when did this occur and what was [95] discussed?

A. I — I know that that meeting was before August 26.

Q. Why do you say that?

A. Because I discussed with him at the meeting what I was going to say and what position I was going to take at the meeting that was scheduled for the 26th. So I know the meeting preceded

that day. Umm, my best memory is that it was a few days before then, but I can't be any more specific than that.

Q. Well, what causes you to think it was a few days before the August 26th meeting?

A. Because I had the meeting on my mind, enough so that I asked, umm, Mr. O'Hagan specifically about what position we ought to take when I went to that meeting.

Q. And his response, generally?

A. His view was, ah, the same as mine at the time, that, ah, this was the kind of work that, umm, Dorsey and Whitney ought to be able to do in the appropriate circumstance.

Q. And during this meeting, did the defendant, James O'Hagan, ever say anything with respect to Pillsbury?

A. Yes, he did.

Q. Well, maybe I better back up. Can you sort of walk us through the meeting and tell us how the conversation began?

A. Well, I remember, ah, being at my desk, and I remember, ahm, Jim O'Hagan coming to my — into my office and standing [96] inside the doorway And talking with me as he was standing there. He began the conversation by saying that he understood that I was doing work on a takeover of the Pillsbury Company, and that, ahm, I would remember, as he put it, that he hated the Pillsbury Company —

Q. And what did you you understand that reference to refer to?

A. I had known for a good long time that Jim had a substantial case against the Pillsbury Company, or one of its subsidiaries, Green Giant, and that, umm, there had been a relatively high degree of animosity in the lawsuit. So that when he said that, that's what I thought, that he was referring to the case involving Green Giant.

Q. Okay. Keep walking us through it.

A. In any event, he, ah, he said, well, you know, I, I, umm, I don't like them, or I dislike them, and I would be interested in working on this case. Umm —

Q. And what was your reaction to that?

A. Well, my reaction was negative, and I said, umm —

Q. Why was your reaction negative?

A. My reaction was negative for two reasons, as I recall. First of all, umm, Jim O'Hagan and I had substantially different manners of approaching cases. And, umm —

Q. Explain that —

MR. HAWKINS: Well, Your Honor, that's irrelevant, [97] beyond that.

THE COURT: Sustained.

BY MR. BEBEL:

Q. Okay. So what was — what was your reaction?

A. What did I say?

Q. What did you say?

A. What I said to him was that I didn't believe that there was, umm, a lot of legal work developing on this. And, umm, it didn't seem like that would be something that would make any sense. Or words to that effect.

Q. And did you, ah, also alert him as to this tension?

A. Well, I remember saying to him t' at there was a question about whether we were going to continue this representation, and that I had to go to a meeting to discuss this with our corporate department that was taking its usual position that we shouldn't be doing this. And I ask him what he thought about it.

Q. And that's when he gave the response you previously discussed?

A. Correct.

Q. Now, who was more senior in the firm at the time?

A. He was.

Q. And does the fact that he was more senior in the firm have any bearing on your ability to remember this conversation?

[98] A. Yes.

Q. Explain that.

A. In a law firm, a large law firm like the one we were both in, typically the more senior lawyers are in charge of matters and the more junior lawyers work for them, and in fact, ahm, when I had started at Dorsey and Whitney and for six or seven years thereafter I worked on a number of matters, ah, for Jim O'Hagan when he was in charge of them. So that this was an unusual circumstance for me with somebody who was more senior in the trial department coming and asking me to work on a case where I was in charge.

Q. Okay. Let's move on a little bit. At the time he came into your office and began discussing this, did you — well, why was it that you were willing to discuss this matter with him? Did you think you were doing anything improper?

A. No. And as to the question why, umm, the first answer — the first part of the answer is because he asked, and the second is because he was a partner in the Dorsey and Whitney law firm.

Q. Well, what does that mean?

A. Umm —

Q. In what way did that, ah, allow you to think it was proper to discuss this with him?

A. Well, there may be some circumstances in which we try to keep information narrowly confined within the law firm about [99] a client matter. The practical fact is, and the legal fact is, that all partners are charged with the same knowledge, whether they really know it or not. So that, umm, any partner in the law firm has the right to know what is being done by the partnership. That's the essence of a partnership, as far as I'm concerned.

Q. Well, at this time, the time of the discussion, did you have any indication that the defendant was purchasing Pillsbury securities?

A. None at all.

Q. At any time during August did you obtain information of that sort?

A. Not one suggestion.

Q. How about September, at any time during September did you ever obtain any information whatsoever that suggested that the defendant was purchasing Pillsbury securities?

A. Not the slightest hint.

Q. What causes you to be so sure of that?

A. Because my reaction would have been very, very substantial had I learned of that or heard of that during that period of time.

Q. Why?

A. I would have considered that to be a very significant problem for the firm and an enormous breach of trust.

Q. Why?

[100] A. Because as lawyers representing a client, we have an obligation not to use information from that client for our

own benefit. Under the securities trading laws of the United States, as I understand them, it would be improper to use information gained through private client communications to profit individually by virtue of trading. For both of those reasons, that is it's a breach of ethics and it's a breach of the law, I would have been more than a little upset.

Q. And ultimately, was a tender offer for Pillsbury securities made?

A. Ultimately it was.

Q. October 4th sound like the general time frame?

A. All I can tell you is that I remember it was early October.

Q. And do you recall whether the SEC, Securities and Exchange Commission, then ever made any contact with anyone at the firm?

A. I remember about a month later being called to a meeting in Peter Dorsey's office regarding a call from the SEC.

Q. And after that did you ever have a conversation with Bob Struyk that related to the defendant's trading?

A. Ah, yes, I'm sure I did.

Q. Do you recall generally what position you took as to the defendant's trading during those conversations, during that [101] conversation?

MR. HAWKINS: Your Honor, what his position is on

November 22nd is irrelevant. Or November 2nd, whatever, at this meeting.

MR. BEBEL: Your Honor, I believe we opened the door to this questioning —

THE COURT: Overruled. Or sustained. I beg your pardon.

MR. BEBEL: We have nothing further, Your Honor.

THE COURT: All right.

MR. HAWKINS: May we approach the bench, Your Honor?

THE COURT: Surely.

(Side bar discussion.)

MR. HAWKINS: I'm just curious about time, Your Honor.

THE COURT: We're going to go till quarter past.

MR. HAWKINS: Okay. That's all I wanted to know.

MR. HOPEMAN: I didn't hear any of that.

MR. BEBEL: We're going to quit quarter past.

(Open court.)

(Discussion off the record.)

Appendix A

THE COURT: Cross-examination, counsel?

MR. HAWKINS: Can I see it? Thanks. (To witness.)

[102] CROSS EXAMINATION

BY MR. HAWKINS:

Q. You've got a envelope with the received stamp January 4th, 1994, 1604, is that where your office is?

A. It is.

Q. And this was delivered to you?

A. It was.

Q. And it's from Chris Bebel?

A. This was delivered to me, the two statements at the end. The articles I put in there myself this morning.

Q. Okay. And the statements were sent to you to review before you came in to testify, sir?

A. That's correct.

Q. Is that correct?

A. That's correct.

Q. And then you also put in these other files?

Appendix A

A. I put in some newspaper articles.

Q. These newspaper articles?

A. That's correct.

Q. Now, those relate to a situation called Allegheny, correct?

A. That's correct.

Q. Now, during 1987 and 1988, you were involved in some litigation relating to Allegheny, correct?

A. Correct.

[103] Q. And do you recall having a conversation with Mr. O'Hagan relating to the subject matter of Dorsey and Whitney not becoming involved in litigation relating to hostile takeovers?

A. I recall a, the discussion that I just related about hostile takeovers in connection with Pillsbury.

Q. Did you have any discussion with him in regard to Allegheny?

A. Not that I recall.

Q. On August 26th, 1988, you were in the midst of working on Allegheny, were you not?

A. Ah, yes, I was working on a brief.

Q. You had stuff all over your office, as a lot of lawyers working on briefs do, relating to the Allegheny case?

A. That would have been true for most of '87 and most of '88.

Q. Now, this conversation on August 26th between and you Mr. O'Hagan that you related, only lasted approximately three to five minutes, correct?

A. First of all, I don't believe it was on August 26th.

Q. I apologize.

A. That's all right. It was sometime — somewhat earlier than that, and I agree with your time frame. My memory tells me it was relatively short, and he stood in my office during it.

[104] Q. It was a very what could be considered short and concise conversation, correct?

A. Well, it was three to five minutes, I'll agree with that.

Q. And in that regard, you recall during that conversation ever talking about — let me go back for a second. You're the head of the trial department at this time, correct?

A. I was, yes.

Q. You're the guy that you have to go to to talk about issues relating to matters in the department, correct?

A. Some issues, sure.

Q. One of the issues that you had to deal with with Mr. O'Hagan was an issue relating to partners sharing secretaries, correct?

A. Yes.

Q. And one of the issues that Mr. O'Hagan advised you he needed to talk to you about on or about the 26th was this issue about having to share a secretary with partners, correct?

A. I think that general issue was quite a bit earlier than this.

Q. You don't recall any of that on the 26th or thereabouts when this conversation occurred?

A. I don't recall anything on the 26th or 25th or 24th having to do with that specific subject, no.

[105] Q. Now, there's no question in your mind that at least the conversation you've related here occurred no earlier than August 24th, correct?

A. Well, all I can tell you is what I said before. I think it was a few days — before the 26th. Whether it was the 25th, the 24th, the 23rd, I can't tell you. I don't think it was earlier than that.

Q. And you've given sworn testimony to that fact previously, correct?

A. I — I've given some sworn testimony in this matter and I know I've talked about the date at which this meeting occurred, so I assume you're right.

Q. Now, there's no question, however, it occurred prior to the meeting with Struyk, possibly Peter Dorsey, possibly Warren Spannaus, Mitou, Swanson, and yourself, correct?

A. That's my best memory.

Q. You never advised any of those individuals at that meeting about a conversation you had for three to five minutes with Mr. O'Hagan within the prior 72 hours, correct?

A. I don't recall specifically doing that.

Q. And security —

A. Although I may have. I just don't recall doing that.

Q. And security, indeed, was an issue, correct?

A. Security in what respect was an issue? I'm sorry, I don't understand your question.

[106] Q. The representation of Grand Met.

A. It was important that the representation of Grand Met in this particular context not be made public.

Q. You never made that known to Mr. O'Hagan, correct?

A. I didn't have that conversation with him, no.

Q. And during this three to five minute conversation, during whatever time frame you had, you never talked to Mr. O'Hagan about Grand Met, correct?

A. You mean specifically mentioned Grand Met?

Q. Correct.

A. I don't remember.

Q. That's something you would have remembered, however, if it had happened, correct?

A. I don't know.

Q. It was important at the time, correct?

A. I don't think that who the acquirer was was particularly important in the conversation, no.

Q. That you guys were having?

A. I don't think it was important in our conversation.

Q. Because what the conversation was about was the general policy at Dorsey and Whitney about being involved in hostile takeovers, correct?

A. No. The conversation was about two things. The first of which was Mr. O'Hagan's desire to work on this specific matter, and the second was our general policy.

[107] Q. So part of the conversation was about a general policy relating to noninvolvement of hostile takeovers of local companies, fair?

A. That's correct.

Q. And the second part of the conversation was Mr. Hagan's willingness to work on this matter, correct?

A. Well, except you have them reversed. That was the first part of the conversation.

Q. I'm not trying to put them in any order, I'm just trying to identify the subjects.

A. Those are the two subjects.

Q. Now, talking about the subject of Mr. O'Hagan volunteering to work on a matter, would be absolutely extremely unusual, based upon his position in that law firm and your prior relationship with him, correct?

A. As I said, it would be unusual.

Q. Highly unusual, correct?

A. Well, it's unusual enough so that, umm, it hadn't happened more than once or twice to me.

Q. Never happened with Mr. O'Hagan before, correct?

A. That's correct.

Q. And is it fair to say that when you went to this meeting on the 26th, that you had your own views on what should occur, correct?

A. That's correct.

[108] Q. And one of the views, without any question about it, was you should be involved in this litigation if indeed, quote, unquote, it engaged, or involved substantial legal work. Correct?

A. That was my view, that that's what we should do.

Q. If it did not involve substantial legal work, you didn't feel the firm should be involved, correct?

A. That is correct.

Q. So if it involved handshaking, political-type stuff, you didn't know whether you should be involved in just that limited role, true?

A. I would not have been comfortable doing that.

Q. And you also would not have been comfortable, to use a lawyer's term, to carry Cravath's hand — or briefcase?

A. That's correct. And that means to me that I'm not doing legal work I'm doing carrying box work.

Q. Grunt work.

A. Well, whether it's grunt — that's not a legal term.

Q. No, military term?

A. To me it means that I'm not being asked to do legal work in the sense of practicing law.

Q. And anything like that is normally delegated to an associate, correct?

A. Yes.

Q. Now, another reason that you espoused at this meeting in [109] support of your position to be involved adversely to Pillsbury on behalf of Grand Met was because everybody knew Pillsbury was on its last legs and they believed that a makeover was imminent, correct?

A. I think that, ah, my view was that Pillsbury wasn't in very good condition, and that the perception that people in the community would have was that it wasn't so much perhaps hostile as helping out, because of the perception in the community that Pillsbury wasn't the strongest of companies.

Q. And you believed and espoused at this meeting that their takeover was imminent, correct?

A. I don't recall specifically using those words, but that was my — my general feeling was that something was going to happen with Pillsbury sooner or later.

Q. And so whether you were representing an outside company or not didn't make any difference, fair?

A. Oh, it made a difference. But this is one of the things that you weigh in the balance. One of the factors you take into consideration.

THE COURT: Just a second, counsel. As a matter of fact, why don't we take a break, this would be a reasonable time to take a break for lunch.

MR. HAWKINS: May I finish just this one line of questioning I was on?

THE COURT: You certainly can.

[110] MR. HAWKINS: I appreciate it, Your Honor, I'm sorry.

THE COURT: No problem. No problem.

Q. This is your copy, correct?

A. This is what Mr. Bebel sent me a couple days ago.

Q. Whose writing is it?

A. Mine.

Q. Your corrected version?

A. Yes.

Q. You went through and you adopted what was said in there, changed it to say the way you felt you agreed?

A. To an extent, yes.

Q. And is it fair to say, read along with me, Tinkham said that he believed they should —

MR. BEBEL: Your Honor, we object to reading documents that are not in evidence.

MR. HAWKINS: It's going to be impeachment, Your Honor.

MR. BEBEL: Your Honor, it can't be impeachment based on the testimony.

THE COURT: Well, I think we will pick it up after lunch.

MR. HAWKINS: Okay.

THE COURT: All right.

[111] MR. HAWKINS: Oh, this is yours.

THE WITNESS: Yeah.

THE COURT: Ladies and gentlemen, we will return at, ah, why don't we come back at 2 o'clock. Two. One of those bankers lunches today, ladies and gentlemen.

(Jury in recess.)

THE COURT: Counsel, may I suggest that it would be prudent for you to get your program together so that rather than introducing two exhibits, 56 and 11, or whatever it is, you pick your favorites and get them together. Somehow I was under the impression that the government was of a view that what you offered may not have been exactly what you were supplied, and I know you were — whatever it is, why don't you guys straighten this out if you can.

MR. HAWKINS: I can explain exactly what the problem is.

THE COURT: Oh, I'm sure I don't need an explanation if you can take care of it. Otherwise we'll go into it as you need.

MR. BEBEL: We'd like to make this exhibit, the documents that were taken off of they have nothing to do, ah, with his Exhibit entirely different. Mr. Hopeman went through both sets of documents at the break, and I believe there's been inference made to the jury that —

[112] THE COURT: Oh, there's no inference to the jury, my heavens. Counsel, I've explained to them you guys just were tiffing.

MR. BEBEL: We thank you for caring, then.

THE COURT: Close enough, as well as I'm able.

MR. HAWKINS: The only exception I take, they have nothing to do, Defendant's Exhibit 19 is the quote, unquote, billing memorandum that was generated on November 10th, 1988 —

THE COURT: I bet you can straighten it out.

MR. HAWKINS: This, well, I just want the record to reflect what this is.

THE COURT: It's reflected whatever you want, counsel. Straighten it out, will you?

MR. HAWKINS: I think it is straightened out.

THE COURT: You guys can get your heads together and I'm sure you can handle it.

Now, then, where are we with respect to a statement — a

holographic statement and personal adoption of a statement of a witness as opposed to being a straight 302, which I suspect is what you're talking about here?

MR. BEBEL: You mean reading that statement for impeachment purposes?

THE COURT: Well, I'm not sure what he has in mind here. What's impeaching?

[113] MR. HAWKINS: His position stated at that meeting, according to what he represented, what I —

THE COURT: Sir, I think you can actually step out. I'll take this up — you also can be seated. It's just more comfortable for me to stand here, folks.

MR. HAWKINS: I'm using his document that he read that he has corrected, written on, changed, which says that his opinion for continuing representation, and I'm paraphrasing, was because, and now I'm quoting, a takeover of Pillsbury was imminent.

THE COURT: I don't find that impeaching. What he said was his view was he said was he didn't recall whether or not that was what he said, and I don't see that that's impeaching.

MR. BEBEL: Your Honor, with respect to impeaching the out-of-court declarant by way of the judgment and conviction, or even by way of other 404(b) acts, do you want us to brief that and bring it up to you at a later point in time? What's your preference?

THE COURT: If you feel better briefing it, you feel free to do that. See you at 2 o'clock.

(Recess.)

THE COURT: Mr. Hawkins, you have some questions?

BY MR. HAWKINS:

Q. Mr. Tinkham, I believe before the recess we were talking [114] about the meeting on the 26th with Mr. Struyk and the other individuals, including Mitou and Swanson, correct?

A. Yes.

Q. I'm not trying to pick words, sir, but one of the things was at that meeting, at least the subject that was discussed and the consensus that was reached was that the situation for Pillsbury on or about August 26th, 1988, was that they were going to be taken over by somebody, fair?

A. No.

THE COURT: Mr. Hawkins, you're going to have to speak up again.

THE WITNESS: That — that was — I'm sorry, Your Honor. Do you want to repeat the question?

BY MR. HAWKINS:

Q. One of the reasons espoused for a continued involvement in this matter was because it was clear, or it was apparent that

the status of Pillsbury was that somebody was going to take it over during this time frame, around August 26th, 1988?

A. I don't think that's quite accurate in terms of my perception at the time, because if somebody had been — had it been apparent that somebody was going to take it over, the stock price would have been climbing. What was apparent yes that Pillsbury was not a very strong company, and that either it was going to get stronger, that somebody was going [115] to acquire it, that its management was going to get better, something had to happen, and something had to happen relatively soon, but what, was another matter.

Q. Did you tell those people at that meeting that a takeover was imminent?

A. I don't recall using those words.

Q. Did you tell them a takeover was going to happen sooner or later?

A. I don't recall saying that either. I recall saying more along the lines what I just described to you. That that was one of the possibilities.

Q. On the other hand, there was a concern about the fact that Grand Met had holdings in South Africa, correct?

A. Yes.

Q. And another concern about continued representation was the fact that they were involved in the wholesale liquor business?

A. That was a minor concern.

Q. And it was determined that at least for the present, they would agree that whether or not continued representation would occur would be subject to another meeting, and some of these issues would be looked into, correct?

A. Yes.

Q. And approximately 14 or 15 days later, two weeks, a [116] decision was made for the firm to withdraw?

A. Ah, approximately. It was made about, umm, oh, the 8th or 9th or so of September.

Q. And back to on or about August 24th, 25th, 26th, you're aware of a lot of conversation in the Twin Cities area about Pillsbury being a takeover target, correct?

A. No.

Q. Didn't talk to anybody about it?

A. I don't recall talking to anybody about it being a likely takeover target.

Q. No conversation with any people in the business community about newspaper articles?

A. No, I don't think so.

Q. Did you read the newspaper articles about Pillsbury?

A. I sure did.

Q. And that was not a discussion you engaged in with anybody?

A. Oh, I don't know, I can't answer that absolutely. I — I don't recall ever talking to somebody in the business community about it. That I think I might remember.

Q. Did you ever talk to a friend of yours by the name of Tom Kelly about it when you were running over the noon hour?

A. I don't recall.

Q. Is that something you guys would have talked about?

A. Umm, not specifically, no.

[117] Q. He's a lawyer, correct?

A. Correct.

Q. Good friend of yours?

A. He is.

Q. Do you remember talking to any people over at the Minneapolis Athletic Club during the lunch hour about all the conversation about, or the newspaper articles about Pillsbury?

A. No, I don't.

Q. Is it fair to say you don't invest in stocks very much?

A. Ahm, no, that's not fair to say.

Q. Okay. Do you consider yourself a sophisticated investor as Mr. O'Hagan is?

A. No.

Q. He's quite a sophisticated investor, correct?

A. I don't know, but I don't consider myself a sophisticated one, and I don't know whether he is or not.

Q. Okay, Now, in regard to your tenure with Dorsey and have you ever opened a takeover file?

A. Umm, other than participating in this one, I don't believe so.

Q. Did you open the file in this case?

A. Ah, my memory is that Peter Dorsey initiated it, but I sure signed it.

Q. And that would relate to the conversation you had with [118] Mr. Struyk about opening the file on or about July 30th, 1988?

A. Well, he and I talked about it, I don't know if that date's correct.

Q. Do you recall testifying on November 22nd, 1988, that you've never opened a takeover file?

A. Ah, I don't remember that, but, ah, that may well be.

Q. Direct your attention to page 25, folio 21, 22, 23, just read that to yourself and tell me when you're completed?

A. I'm through.

Q. Does that refresh your recollection?

A. Yes.

Q. Is that a fair recitation of what your testimony was?

A. I believe it is.

Q. It's kind of hard to keep all this stuff straight sometimes, isn't it?

A. Well, some of it.

MR. HAWKINS: I have no further questions, Your Honor.

THE COURT: Any further direct?

MR. BEBEL: Can we have a minute, Your Honor?

THE COURT: Certainly.

(Pause)

MR. BEBEL: And we have nothing further.

THE COURT: You may step down, Mr. Tinkham, thank

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Supreme Court, U.S.
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No. 96-842

In the Supreme Court of the United States

OCTOBER TERM, 1996

UNITED STATES OF AMERICA, PETITIONER

v.

JAMES HERMAN O'HAGAN

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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9 pp

TABLE OF AUTHORITIES

Cases:	Page
Carpenter v. *United States*, 484 U.S. 19 (1987)	6, 7
Central Bank of Denver, N.A. v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994)	4, 5
Chevron U.S.A. Inc. v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984)	3
Ernst & Ernst v. *Hochfelder*, 425 U.S. 185 (1976)	5
SEC v. *Maio*, 51 F.3d 623 (7th Cir. 1995)	4
United States v. *Mylett*, 97 F.3d 663 (2d Cir. 1996)	4
United States v. *Newman*, 664 F.2d 12 (2d Cir. 1981), cert. denied, 464 U.S. 863 (1983)	6
United States v. *ReBrook*, 58 F.3d 961 (4th Cir.), cert. denied, 116 S. Ct. 431 (1995)	7
Statutes and regulations:	
Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677	5
Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq.*:	
§ 10(b), 15 U.S.C. 78j(b)	5
§ 14(e), 15 U.S.C. 78n(e)	3
17 C.F.R.:	
Section 240.10b-5	2, 4, 5
Section 240.14e-3	3
Section 240.14e-3(a)	2, 4
Miscellaneous:	
H.R. Rep. No. 355, 98th Cong., 1st Sess. (1983)	6
H.R. Rep. No. 910, 100th Cong., 2d Sess. (1988)	5

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1. Respondent contends (Br. in Opp. 13-15) that the evidence at trial was insufficient to show that he traded in Pillsbury securities on misappropriated, nonpublic material information about Grand Metropolitan's plan to acquire Pillsbury stock. He argues that he did not learn, from his conversation with Thomas Tinkham, the identity of the client that had retained Dorsey & Whitney in connection with the acquisition of Pillsbury; that Grand Met's designs on Pillsbury were known to the public by that time; that Grand Met had not decided to take over Pillsbury by the time of his conversation with Tinkham; and that he had begun acquiring Pillsbury securities even before his conversation with Tinkham.

Respondent's factual assertions are either incorrect or irrelevant.[1] More importantly, however, they provide no basis for the Court to deny review of the legal issues presented by the petition. The court of appeals reversed respondent's convictions, not because of insufficient evidence, but because it held that the theories of criminal liability under SEC Rule 10b-5, 17 C.F.R. 240.10b-5, and SEC Rule 14e-3(a), 17 C.F.R. 240.14e-3(a), that formed the basis of his prosecution are not valid. See Pet. App. 1a-2a. Those are the issues raised by our petition.

Furthermore, the factual issues raised by respondent were rejected by the jury. The trial court instructed the jury that, among the essential elements of a Rule 10b-5 violation in this case was that "the defendant gained access to, and then misappropriated material, nonpublic information, which was to be used

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[1] Respondent's contention that Grand Met's plans were not secret is belied by the security precautions taken by his law firm (Pet. 4). His claim that Grand Met did not have a plan to take over Pillsbury is undercut by the retention of Dorsey & Whitney to help implement that plan. Whether or not Grand Met's Board of Directors had formally implemented a course of action to acquire Pillsbury by hostile takeover (see Br. in Opp. 2), Grand Met had taken substantial steps to acquire Pillsbury by the time of respondent's conversation with Tinkham. Whether or not respondent's trades before his conversation with Tinkham were lawful, his acquisitions of Pillsbury securities after that conversation were trades on the material, nonpublic information that he obtained in that conversation. Finally, respondent's purported ignorance of the client's name does not negate his fiduciary duty to that client. The material, nonpublic information (which respondent unquestionably possessed) was that a tender offer for Pillsbury was being planned by a client of his law firm. Respondent owed a duty of trust and confidence to that client, whatever its identity.

only for Grand Met's purposes through a relationship of trust and confidence." 2/8/94 Tr. 27-28; see *id.* at 28-29 (instructing that, to convict respondent, jury must find that respondent owed a duty of trust and confidence to either Grand Met or Dorsey & Whitney, or both). The court further instructed that the government was required to prove that the pertinent information was both material and nonpublic. *Id.* at 31-32. As to the Rule 14e-3 charge, the court noted that "it is claimed that [respondent] purchased these securities after Grand Met had taken substantial steps toward the making of a tender offer." *Id.* at 35-36.[2] The court instructed that, under Rule 14e-3, the government was required to prove, among other things, that "Grand Met ha[d] taken a substantial step or steps to commence a tender offer for the stock of Pillsbury; * * * that [respondent] was in possession of material information relating to this tender offer, and [respondent] knew the information was material; * * * [and that] the information was nonpublic and

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[2] Respondent contends (Br. in Opp. 29) that no "tender offer" existed until the Board of Directors of Grand Met finally authorized and announced one, and therefore his trades, which took place before the announcement, could not have violated Section 14(e) or Rule 14e-3. Section 14(e), however, prohibits fraud, and authorizes the SEC to adopt rules to define and prevent fraud, "in connection with" any tender offer. See 15 U.S.C. 78n(e). The SEC, in Rule 14e-3, has construed the "in connection with" language to encompass situations where a bidder has taken "a substantial step or steps to commence * * * a tender offer." That reading is a reasonable construction of the statute entitled to deference. *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). In this case, Grand Met had taken "a substantial step or steps," by retaining counsel and otherwise preparing for its eventual tender offer. See Pet. App. 2a.

[respondent] knew the information was nonpublic." *Id.* at 38.

The jury found respondent guilty under those instructions, and therefore necessarily concluded that the government had established, beyond a reasonable doubt, that respondent traded on material, nonpublic information about the takeover of Pillsbury. The trial court also denied respondent's motion for acquittal. 10/27/94 Tr. 24-25. Accordingly, respondent's claim of insufficient evidence provides no basis for denying the petition for a writ of certiorari.

2. Respondent argues (Br. in Opp. 15-16, 18) that there is no true circuit conflict on the validity of the misappropriation theory of liability under Rule 10b-5 or the validity of Rule 14e-3(a) because no court of appeals has expressly considered the validity of the misappropriation theory or Rule 14e-3 in light of this Court's decision in *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). In fact, since *Central Bank*, both the Second and Seventh Circuits have reaffirmed their previous approvals of the misappropriation theory. See *United States* v. *Mylett*, 97 F.3d 663, 666-667 (2d Cir. 1996) (upholding Rule 10b-5 liability based on information about planned takeover misappropriated from acquiring company); *SEC* v. *Maio*, 51 F.3d 623, 631, 633-634 & n.12 (7th Cir. 1995) (same).[3] And the Seventh Circuit in *Maio* also expressly upheld the validity of Rule 14e-3. *Id.* at 634-635. There exists, therefore, a live circuit conflict on both issues warranting this Court's review.

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[3] The Ninth Circuit has not addressed the misappropriation issue since *Central Bank*. The issue is presented in *SEC* v. *Goldinger*, No. 95-56092 (9th Cir.) (argued Nov. 6, 1996).

Moreover, *Central Bank* did not announce any principles of analysis that would warrant reconsideration of the validity of the misappropriation theory or Rule 14e-3. *Central Bank* did not involve the validity of any theory of primary liability for securities fraud; the question in that case was whether there is a private cause of action against an alleged aider and abettor of a violation of Section 10(b) and Rule 10b-5. 511 U.S. at 167. That issue has no relevance here, for respondent was convicted as a primary violator of the securities laws. And although respondent contends that *Central Bank* changed the principles of statutory construction applicable to the securities laws by emphasizing that "the text of the statute controls" (Br. in Opp. 16), that principle is well established in this Court's decisions interpreting Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b). See, *e.g.*, *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 197 (1976). In fact, the *Central Bank* decision itself applied "settled methodology," as described "in earlier cases." 511 U.S. at 177.

3. Respondent also argues (Br. in Opp. 21-22) that, in the legislative history of the Insider Trading and Securities Fraud Enforcement Act of 1988, Congress "expressed doubts" as to the validity of the misappropriation theory. Respondent discerns such "doubts" in a statement in a committee report to the effect that the status of the misappropriation theory was then "unresolved nationally." H.R. Rep. No. 910, 100th Cong., 2d Sess. 10 (1988). That statement reflected the fact that, at the time it was made, no court of appeals other than the Second Circuit had expressly adopted (or in fact had considered) the theory. Far from expressing doubts about the validity of the misappropriation theory, however, the House Energy

and Commerce Committee expressed its approval of the theory in the very next sentence of the report when it stated: "In the view of the Committee, however, this type of security fraud should be encompassed within Section 10(b) and Rule 10b-5." *Ibid.*; see also *id.* at 26-27 (the misappropriation theory "fulfills appropriate regulatory objectives in determining when communicating or trading while in possession of material nonpublic information is unlawful"). In fact, as early as 1984, the House Committee Report accompanying the Insider Trading Sanctions Act of 1984 cited with approval the Second Circuit's misappropriation decision in *United States* v. *Newman*, 664 F.2d 12 (1981), cert. denied, 464 U.S. 863 (1983). See H.R. Rep. No. 355, 98th Cong., 1st Sess. 5 n.8. (1983).

4. Finally, respondent argues that the court of appeals' reversal of his mail fraud convictions does not conflict with this Court's decision in *Carpenter* v. *United States*, 484 U.S. 19 (1987), because the court of appeals expressly recognized that, under *Carpenter*, "where both mail fraud and securities fraud counts are brought, they are [not] necessarily interdependent." Br. in Opp. 30. That argument is without merit.

While the court of appeals purported to follow this Court's holding in *Carpenter*, its analysis sharply departed from that decision. The court of appeals stated that, because respondent's "conduct did not constitute securities fraud, * * * there was no fraud upon which to base the mail fraud charges." Pet. App. 37a. Under that analysis, a court could never uphold a mail fraud count if the underlying conduct also formed the basis of a securities fraud count that was dismissed by the court. *Carpenter* makes clear, however, that mail fraud charges are independent of securities fraud charges even when both rest on the

same facts. The Court in *Carpenter* unanimously affirmed the petitioner's mail and wire fraud convictions, even though the Court was evenly divided with respect to the securities fraud counts. Accordingly, contrary to the court of appeals' holding, a defendant may be punished for mail fraud even if the indictment "premise[s] the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud." Pet. App. 37a. See also *United States* v. *ReBrook*, 58 F.3d 961, 967 (4th Cir.), cert. denied, 116 S. Ct. 431 (1995). Accordingly, the Court should grant review of the court of appeals' decision on the mail fraud counts in this case to reaffirm *Carpenter*'s holding that acts may constitute mail fraud, whether or not those same acts violate other prohibitions against fraud as charged in the indictment.

* * * * *

For the forgoing reasons, and also for the reasons set forth in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

WALTER DELLINGER
Acting Solicitor General

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No. 96-842

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

JOINT APPENDIX

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ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

JOINT APPENDIX

TABLE OF CONTENTS

Page

Relevant Docket Entries, United States Court of Appeals for the Eighth Circuit 1

Relevant Docket Entries, United States District Court for the District of Minnesota 3

Indictment (December 16, 1992) 6

Government Exhibit 53 (Dorsey & Whitney confidentiality policy) 26

Government Exhibit 56 (Dorsey & Whitney document on Cravath file) .. 32

Government Exhibit 75 (transcript of respondent's deposition) 37

Government Exhibit 78 (chart of trades) 55

Defendant's Exhibit 9
(*Investment Dealers Digest* article) 56

Trial Transcript (January 19, 1994) 57
Government opening statement 58

Trial Transcript (January 20, 1994) 61
Testimony of J. Jackson 62
Testimony of Michael Kennedy 68
Testimony of William Brownlie 83

Trial Transcript (January 24, 1994) 93
Testimony of Charles Alan Parker 94

Trial Transcript (January 25, 1994) 113
Testimony of John Schenk 114
Testimony of Robert Struyk 115
Testimony of Thomas Tinkham 123
Testimony of Douglas Carnival 134
Testimony of Daniel Stibile 137
Testimony of Judy Kallaus 142

Trial Transcript (January 26, 1994) 151
Testimony of Judy Kallaus 152
Testimony of Michael Mulligan 154
Testimony of David Kukura 157

Trial Transcript (January 31, 1994) 163
Testimony of James Consideine 164
Colloquy between Court and Counsel 167
Testimony of Patricia Kinnahan 169

Trial Transcript (February 1, 1994) 173
Testimony of Stuart Evans 174

Trial Transcript (February 3, 1994) 179
Testimony of Paul Walsh 180

Trial Transcript (February 7, 1994) 185
Testimony of Dennis Mathisen 186
Government closing argument 189

Trial Transcript (February 8, 1994) 191
Jury charge 192

Sentencing Transcript (October 27, 1994) 207
Denial of motion for acquittal 208

Judgment of conviction and sentence
(November 2, 1994) 209

Timeline used in oral argument before court of
appeals (October 17, 1995) 214

Order granting certiorari (January 17, 1997) 215

NOTICE

The following items have been omitted in printing this appendix because they appear on the following pages in the printed appendix to the petition for a writ of certiorari:

Magistrate's report and recommendation
(September 10, 1993) 40a

District court opinion on pending motions
(December 30, 1993) 73a

Court of appeals opinion (August 2, 1996) 1a

Court of appeals order denying rehearing
(November 13, 1996) 75a

In addition, the entire trial testimony of Thomas Tinkham is reprinted in the appendix to respondent's brief in opposition to the petition for a writ of certiorari, at 1a-39a.

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 94-3714

UNITED STATES OF AMERICA, PLAINTIFF-APPELLEE

v.

JAMES O'HAGAN, DEFENDANT-APPELLANT

RELEVANT DOCKET ENTRIES

DATE	PROCEEDINGS
10/20/95	28(j) citation and hand out of the exhibit entitled "Timeline of Important Events" received and filed from Appellant James Herman O'Hagan in 94-3714, Appellee James Herman O'Hagan in 94-3856 TO COURT. [94-3714, 94-3856] [631805] (rla) [94-3714 94-3856]
8/2/96	THE COURT: George G. Fagg, Donald P. Lay, David R. Hansen. OPINION FILED by David R. Hansen PUBLISHED, DISSENT by George G. Fagg. [94-3714, 94-3856] [740365] (lcd) [94-3714 94-3856]

DATE	PROCEEDINGS
8/2/96	JUDGMENT: George G. Fagg, Donald P. Lay, David R. Hansen: The judgment of the lower court is REVERSED and REMANDED in accordance with the opinion. [94-3714] [740367] (lcd) [94-3714]
11/13/96	JUDGE ORDER: denying petition for Rehearing with suggestion for rehearing en banc [756682-1] filed by USA. Petition for panel Rehearing is also denied. Judge McMillian would grant the suggestion. [94-3714, 94-3856] Chief Judge Richard S. Arnold, Judge Magill, Judge Loken, and Judge Murphy took no part in the consideration or decision of this case. [779217] in 94-3714, 94-3856 (mls) [94-3714 94-3856]

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MINNESOTA

No. 0864-4: Cr. 4-92-219

UNITED STATES OF AMERICA, PLAINTIFF

v.

JAMES O'HAGAN, DEFENDANT

RELEVANT DOCKET ENTRIES

DATE		PROCEEDINGS
12/16/92	1	INDICTMENT assigned to Judge James M. Rosenbaum, referred to Magistrate Judge J. Earl Cudd by USA Lynn A Zentner & Christopher J Bebel. Counts filed against James Herman O'Hagen (1) count(s) 1-20, 21-37, 38-54, 55, 56, 57. Warrant issued for James Herman O'Hagen. 21 pgs (dd) [Entry date 12/17/92] [Edit date 12/17/92]
		* * * * *
9/10/93	50	REPORT and RECOMMENDATION by Magistrate Judge J. Earl Cudd date signed: 9/10/93 recommends motion by

DATE		PROCEEDINGS
		defendant James Herman O'Hagen to dismiss counts 21-54 for improper venue be DENIED [46-1] RR Ruling deadline set for 10/12/93 for James Herman O'Hagen (cc: all counsel) (31 pgs) (bw) [Entry date 09/10/93]
		* * * * *
12/30/93	86	ORDER by Judge James M. Rosenbaum that: 1. Deft's motion to dismiss Counts 21 through 54 of the indictment for improper venue is denied. 2. Deft's motion to dismiss the indictment, and his supplemental motion to dismiss, is denied. 3. Jury selection in this matter will commence, as previously determined, on January 3, 1994, and trial will commence January 11, 1994 (cc: all counsel) Date Signed: 12/30/93 (4 pgs) (bw) [Entry date 12/30/93]
		* * * * *
10/27/94	145	MINUTES: before Judge James M. Rosenbaum sentencing James Herman O'Hagen (1) count(s) 1-20, 21-37, 38-54, 55, 56, 57. Deft. is committed to the custody of the US for imprisonment for a term of 41 months. Deft. to be given credit for time served amounting to 23 months. Deft. has 18 months remaining. Deft. to pay $150,000 fine. Deft. to serve 3 yrs supervised release. The Court recommends the Duluth Prison Camp as place of incarceration. Deft. to pay a

DATE		PROCEEDINGS
		special assessment of $2,850.00 for counts 1-57 case terminated Court Reporter: Dawn Sampson (1 pg) (bw) [Entry date 10/31/94] [Edit date 11/07/94]
11/2/94	146	JUDGMENT/STATEMENT OF REASONS as to defendant James Herman O'Hagan by Judge James M. Rosenbaum (Copies dist'd) (5 pgs) (bw) [Entry date 11/02/94] [Edit date 11/07/94]
		* * * * *
11/7/94	149	NOTICE of Appeal to Eighth Circuit Court by defendant James Herman O'Hagan from the judgment entered on 10/27/94 (cc: all counsel) (5 pgs) (bw) [Entry date 11/07/94]

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

UNITED STATES OF AMERICA, PLAINTIFF, v. JAMES HERMAN O'HAGAN, DEFENDANT.	INDICTMENT (18 U.S.C. § 1341) (18 U.S.C. § 1956(a)(1)(B)(i)) (18 U.S.C. § 1957) (18 U.S.C. § 982(a)) (15 U.S.C. § 78j(b)) (15 U.S.C. § 78n(e)) (15 U.S.C. § 78ff(a)) (17 C.F.R. § 240.10b-5) (17 C.F.R. § 240.14e-3(a)) (21 U.S.C. § 853(p))

THE UNITED STATES GRAND JURY CHARGES THAT:

INTRODUCTION

1. At all times material and relevant to this indictment:

a. Grand Metropolitan PLC ("Grand Met") was a diversified corporation based in London, England, that engaged, through various subsidiaries, in a range of businesses, including the production and distribution of alcoholic beverages; owning and operating pubs and restaurants; processing and distributing milk and other food products; manufacturing and selling pet foods; retailing eye care products and services; and operating hotels. On or about October 4, 1988, Grand Met made a tender offer for the common stock of Pillsbury Company. Pursuant to the tender offer, Grand Met offered to purchase all outstanding Pillsbury common stock at $60 per share. The tender offer price of $60 per share represented a sizeable premium over the price of approximately $39 per share at which Pillsbury common stock was trading when the stock market closed on October 3, 1988, the day before the tender offer was made.

b. Pillsbury Company ("Pillsbury") was a publicly-held corporation based in Minnesota and was a diversified international food and restaurant company.

c. Cravath, Swaine and Moore ("Cravath") was a law firm based in New York which was retained by Grand Met in July of 1988 to effectuate the making of a tender offer for Pillsbury common stock.

d. Dorsey and Whitney was a Minnesota based law firm which was retained as local counsel in July of 1988 in connection with Grand Met's tender offer for Pillsbury common stock.

e. Thomas Tinkham was a Dorsey and Whitney partner, assigned to head the team of Dorsey and Whitney attorneys who provided legal services to Grand Met in connection with its tender offer for Pillsbury common stock.

f. Defendant JAMES HERMAN O'HAGAN was a partner in the Dorsey and Whitney law firm. Defendant JAMES HERMAN O'HAGAN maintained banking relationships at various financial institutions, including First Bank, Dakota County State Bank, Investors Savings Bank, Wayzata Bank and Trust, and National City Bank of Minneapolis. Defendant JAMES HERMAN O'HAGAN maintained stock brokerage accounts at various brokerage firms, including Robinson-Humphrey Company, Inc., an affiliate of Shearson Lehman Brothers, Inc.,

Janney Montgomery Scott, Inc. and Dean Witter Reynolds, Inc.

g. Northrup King Company ("Northrup King") was a company based in Minnesota. Northrup King was acquired by Sandoz, Ltd. ("Sandoz"), a company based in Switzerland. Following Northrup King's acquisition by Sandoz, Northrup King forwarded approximately $1,000,000 to Dorsey and Whitney to be placed in a trust account on behalf of Northrup King as part of a settlement between Northrup King and certain individuals who held Northrup King securities prior to its acquisition by Sandoz. Defendant JAMES HERMAN O'HAGAN represented Northrup King and was involved in settlement of the above-described lawsuit.

h. The Mayo Clinic was a Minnesota based health care services entity and Green Tree Acceptance, Inc. ("Green Tree") was a publicly-held corporation based in Minnesota. Both Green Tree and the Mayo Clinic were clients of Dorsey & Whitney. The specific legal services provided by the law firm to these clients were rendered, in part, by defendant JAMES HERMAN O'HAGAN.

THE SCHEME TO DEFRAUD

2. From on or before August 26, 1988, and continuing until approximately October 17, 1988, defendant JAMES HERMAN O'HAGAN engaged in a scheme and artifice to defraud Grand Met and Dorsey and Whitney in connection with the purchase and sale of securities by purchasing Pillsbury common stock and call options on Pillsbury common stock while in the possession of material, non-public information concerning Grand Met's future tender offer for Pillsbury common stock.

3. It was part of the scheme and artifice to defraud that defendant JAMES HERMAN O'HAGAN, directly and indirectly, used instrumentalities of interstate commerce, the mails and facilities of national securities exchanges to engage in acts which operated to defraud Grand Met and Dorsey and Whitney, in violation of Title 15, United States Code, Sections 78j(b) and 78ff(a), and Title 17, Code of Federal Regulations, Section 240.10b-5; and further in violation of Title 15, United States Code, Sections 78n(e) and 78ff(a), and Title 17, Code of Federal Regulations, Section 240.14e-3(a).

4. It was further part of the scheme and artifice to defraud that defendant JAMES HERMAN O'HAGAN, for the purpose of executing the above-described scheme and artifice to defraud, caused certain mail matter, namely, the confirmations of stock trades, to be placed in post offices and authorized depositories for mail, in violation of Title 18, United States Code, Section 1341.

5. It was further part of the scheme and artifice to defraud that defendant JAMES HERMAN O'HAGAN engaged in a monetary transaction affecting interstate commerce, using the proceeds of the above-described scheme to defraud, in an amount in excess of $10,000, in violation of Title 18, United States Code, Section 1957.

6. It was further part of the scheme and artifice to defraud that defendant JAMES HERMAN O'HAGAN engaged in multiple financial transactions involving a bank whose activities affected interstate commerce, which transactions involved the proceeds of the above-described scheme to defraud and were designed to conceal and disguise the true nature and source of the proceeds used, all in violation of Title 18, United States Code, Section 1956(a)(1)(B)(i).

THE MANNER AND MEANS OF CARRYING OUT THE SCHEME TO DEFRAUD

7. It was part of the scheme and artifice to defraud that from on or before August 26, 1988, to on or about October 17, 1988, defendant JAMES HERMAN O'HAGAN intended to use and did use profits obtained by trading while in possession of material, non-public information to conceal his previous embezzlement and conversion of client trust funds.

8. Beginning on or about August 1, 1988, defendant JAMES HERMAN O'HAGAN sought to conceal his previous embezzlement and conversion of client trust funds by replacing these monies. The client trust funds in question amounted to $1 million and were transferred to Dorsey and Whitney in October of 1986 in connection with the settlement of a lawsuit involving Northrup King. These funds were to be held in a Dorsey and Whitney trust account on behalf of Northrup King until a final determination could be made regarding the distribution of these monies to individuals who held Northrup King securities prior to its acquisition by Sandoz.

9. As a Dorsey and Whitney attorney then representing the interests of Northrup King, defendant JAMES HERMAN O'HAGAN had an obligation to safeguard the client trust funds described in paragraph 8 above.

10. Despite the obligation of defendant JAMES HERMAN O'HAGAN to hold the funds described in paragraph 8 above in trust until the time and details for disbursement had been established, beginning on or about October 30, 1986, defendant embezzled and converted the client trust funds which had been forwarded to Dorsey and Whitney by Northrup King by transferring those funds to various bank accounts controlled by

him at First Bank, Dakota County State Bank, Investors Savings Bank, and National City Bank of Minneapolis.

11. In July of 1988, an Order was issued by the United States District Court for the District of Minnesota which required the distribution of the $1 million which Northrup King intended to be held in trust, as described in paragraph 8 above. Knowing that the District Court Order had been issued, defendant JAMES HERMAN O'HAGAN sought, beginning on or about August 1, 1988, to conceal the previous embezzlement and conversion of client trust funds by replacing monies he had taken. In early August of 1988, defendant JAMES HERMAN O'HAGAN replaced a portion of the embezzled and converted Northrup King funds by embezzling and converting $70,000, which was to have been held in trust on behalf of the Mayo Clinic, and by embezzling and converting $115,000 which was to have been held in trust on behalf of Green Tree. Defendant JAMES HERMAN O'HAGAN applied and caused to be applied the funds embezzled and converted from Mayo Clinic and Green Tree to Northrup King's benefit.

12. In or about August of 1988, defendant JAMES HERMAN O'HAGAN further concealed his previous embezzlement and conversion of client trust funds by replacing a portion of the embezzled and converted Northrup King funds, using the proceeds of a loan made to him by Dakota County State Bank.

13. As of August 15, 1988, approximately $550,000 of the embezzled and converted Northrup King funds had not yet been replaced.

14. It was part of the scheme and artifice to defraud that, following a request made by Cravath on or about July 13, 1988, that Dorsey and Whitney provide legal services on behalf of Grand Met in Minnesota in connec-

tion with Grand Met's tender offer for Pillsbury common stock, defendant JAMES HERMAN O'HAGAN learned of the future tender offer and engaged Thomas Tinkham, on or before August 26, 1988, in conversation relative to the tender offer and Dorsey and Whitney's representation of Grand Met in connection with that transaction.

15. It was further part of the scheme and artifice to defraud that defendant JAMES HERMAN O'HAGAN purchased Pillsbury common stock and call options on Pillsbury common stock after coming into possession of material, non-public information relating to the tender offer for Pillsbury common stock.

16. It was further part of the scheme and artifice to defraud that the defendant JAMES HERMAN O'HAGAN held the Pillsbury common stock and call options on Pillsbury common stock until the tender offer for Pillsbury common stock was publicly announced and then sold those securities at prices made higher by the tender offer announcement, realizing a profit of approximately $4,305,025, excluding commissions paid.

17. It was further part of the scheme and artifice to defraud that the defendant JAMES HERMAN O'HAGAN caused approximately $2 million of the profits he made by trading in Pillsbury securities to be transferred from his Robinson-Humphrey stock brokerage account to a First Bank account controlled by him.

18. It was further part of the scheme and artifice to defraud that the defendant JAMES HERMAN O'HAGAN utilized a portion of his profits, approximately $450,736.59, to conceal his previous embezzlement and conversion of Northrup King and Mayo Clinic client trust funds by causing the issuance of two First Bank cashier's checks totalling $450,736.59 and applying the proceeds of the cashier's checks to replace previously

embezzled and converted client trust funds. Neither cashier's check revealed the identity of the remitter.

19. It was further part of the scheme and artifice to defraud that the defendant JAMES HERMAN O'HAGAN utilized a portion of his profits, approximately $299,058.41, to reduce the balance on a loan made to him by the Dakota County State Bank, which loan proceeds had been used by the defendant, at least in part, to conceal his previous embezzlement and conversion of client trust funds.

MAIL FRAUD COUNTS 1 - 20

1. The Grand Jury realleges and incorporates by reference paragraphs 1 through 19 of this indictment as if fully set forth herein.

2. On or about the dates set forth in Counts 1 through 20 in the State and District of Minnesota and elsewhere, the defendant,

JAMES HERMAN O'HAGAN

having devised the aforesaid scheme and artifice to defraud, for the purpose of executing such scheme and artifice to defraud, did cause to be placed in the United States mails to be sent and delivered according to the directions thereon by the United States Postal Service, the items described below, each such use of the mails being a separate count of the indictment:

COUNT	APPROXIMATE DATE	NATURE OF MAIL MATTER	SENDER
01	August 29, 1988	Confirmation Slip for 100 Pillsbury October 40 Call Option Contracts	Robinson-Humphrey
02	August 30, 1988	Confirmation Slip for 100 Pillsbury October 40 Call Option Contracts	Robinson-Humphrey

COUNT	APPROXIMATE DATE	NATURE OF MAIL MATTER	SENDER
03	August 30, 1988	Confirmation Slip for 50 Pillsbury November 45 Call Option Contracts	Janney Montgomery Scott
04	August 31, 1988	Confirmation Slip for 100 Pillsbury October 40 Call Option Contracts	Robinson-Humphrey
05	September 1, 1988	Confirmation Slip for 300 Pillsbury October 40 Call Option Contracts	Robinson-Humphrey
06	September 2, 1988	Confirmation Slip for 222 Pillsbury October 40 Call Option Contracts	Robinson-Humphrey
07	September 6, 1988	Confirmation Slip for 200 Pillsbury October 40 Call Option Contracts	Robinson-Humphrey
08	September 7, 1988	Confirmation Slip for 21 Pillsbury October 40 Call Option Contracts	Robinson-Humphrey
09	September 7, 1988	Confirmation Slip for 79 Pillsbury October 40 Call Option Contracts	Robinson-Humphrey
10	September 7, 1988	Confirmation Slip for 97 Pillsbury October 40 Call Option Contracts	Robinson-Humphrey
11	September 7, 1988	Confirmation Slip for 81 Pillsbury October 40 Call Option Contracts	Robinson-Humphrey
12	September 8, 1988	Confirmation Slip for 50 Pillsbury November 45 Call Option Contracts	Janney Montgomery Scott

All in violation of Title 18, United States Code, Section 1341.

COUNT	APPROXIMATE DATE	NATURE OF MAIL MATTER	SENDER
13	September 8, 1988	Confirmation Slip for 300 Pillsbury October 40 Call Option Contracts	Robinson-Humphrey
14	September 9, 1988	Confirmation Slip for 202 Pillsbury October 40 Call Option Contracts	Robinson-Humphrey
15	September 12, 1988	Confirmation Slip for 198 Pillsbury October 40 Call Option Contracts	Robinson-Humphrey
16	September 19, 1988	Confirmation Slip for 100 Pillsbury November 40 Call Option Contracts	Robinson-Humphrey
17	September 20, 1988	Confirmation Slip for 75 Pillsbury November 40 Call Option Contracts	Robinson-Humphrey
18	September 20, 1988	Confirmation Slip for 100 Pillsbury October 45 Call Option Contracts	Robinson-Humphrey
19	September 20, 1988	Confirmation Slip for 5,000 shares Pillsbury Common Stock	Dean Witter Reynolds
20	September 21, 1988	Confirmation Slip for 125 Pillsbury November 40 Call Option Contracts	Robinson-Humphrey

SECURITIES FRAUD
COUNTS 21 – 37

1. The Grand Jury realleges and incorporates by reference paragraphs 1 through 19 of this indictment as if fully set forth herein.

2. On or before August 26, 1988, while a partner at the Dorsey and Whitney law firm, the defendant acquired material, non-public information relating to Grand Met's future tender offer for Pillsbury common stock.

3. After acquiring information relating to Grand Met's upcoming tender offer for Pillsbury common stock, which information the defendant knew to be material and confidential, and in breach of a duty of trust and confidence owed to Grand Met, and in breach of a duty of trust and confidence owed to the Dorsey and Whitney law firm, the defendant misappropriated the information relating to Grand Met's future tender offer for Pillsbury common stock and purchased Pillsbury common stock and call options on Pillsbury common stock.

4. On or about the dates set forth in Counts 21 through 37 in the State and District of Minnesota and elsewhere, the defendant,

JAMES HERMAN O'HAGAN,

for the purpose of executing the aforesaid scheme and artifice to defraud, knowingly and willfully by use of means and instrumentalities of interstate commerce, the mails and the facilities of a national securities exchange, directly and indirectly, did use and employ manipulative and deceptive devices and contrivances in connection with the purchase and sale of securities, in contravention of Rule 10b-5 (17 C.F.R. § 240.10b-5) of the rules and regulations promulgated by the United States Securities and Exchange Commission, and did (a)

employ devices, schemes and artifices to defraud, and (b) engage in acts, practices and courses of business which would and did operate as a fraud and deceit upon Grand Met and Dorsey and Whitney in connection with the purchase and sale of securities, and as set forth in paragraphs 1 through 3 above, by purchasing Pillsbury common stock and call options on Pillsbury common stock in the following approximate amounts while in the possession of material, non-public information concerning Pillsbury:

COUNT	APPROXIMATE DATE	TYPE OF SECURITY	AMOUNT PURCHASED	BROKERAGE FIRM
21	August 29, 1988	October 40 Call Options	100 Option Contracts	Robinson-Humphrey
22	August 30, 1988	October 40 Call Options	100 Option Contracts	Robinson-Humphrey
23	August 30, 1988	November 45 Call Options	50 Option Contracts	Janney Montgomery Scott
24	August 31, 1988	October 40 Call Options	100 Option Contracts	Robinson-Humphrey
25	September 1, 1988	October 40 Call Options	300 Option Contracts	Robinson-Humphrey
26	September 2, 1988	October 40 Call Options	222 Option Contracts	Robinson-Humphrey

COUNT	APPROXIMATE DATE	TYPE OF SECURITY	AMOUNT PURCHASED	BROKERAGE FIRM
27	September 6, 1988	October 40 Call Options	200 Option Contracts	Robinson-Humphrey
28	September 7, 1988	October 40 Call Options	278 Option Contracts	Robinson-Humphrey
29	September 8, 1988	October 40 Call Options	300 Option Contracts	Robinson-Humphrey
30	September 8, 1988	November 45 Call Options	50 Option Contracts	Janney Montgomery Scott
31	September 9, 1988	October 40 Call Options	202 Option Contracts	Robinson-Humphrey
32	September 12, 1988	October 40 Call Options	198 Option Contracts	Robinson-Humphrey
33	September 19, 1988	November 40 Call Options	100 Option Contracts	Robinson-Humphrey
34	September 20, 1988	November 40 Call Options	75 Option Contracts	Robinson-Humphrey
35	September 20, 1988	October 45 Call Options	100 Option Contracts	Robinson-Humphrey
36	September 20, 1988	Common Stock	5,000 Shares	Dean Witter Reynolds
37	September 21, 1988	November 40 Call Options	125 Option Contracts	Robinson-Humphrey

All in violation of Title 15, United States Code, Sections 78j(b) and 78ff(a), and Title 17, Code of Federal Regulations, Section 240.10b-5.

SECURITIES FRAUD
COUNTS 38 – 54

1. The Grand Jury realleges and incorporates by reference paragraphs 1 through 19 of this indictment as if fully set forth herein.

2. Pursuant to a course of action involving a tender offer for Pillsbury common stock, and before defendant JAMES HERMAN O'HAGAN began a course of trading in Pillsbury common stock and in call options on Pillsbury common stock while in possession of material, non-public information, substantial steps were taken by Grand Met as more particularly set forth below:

a. On or about March 23, 1988, Grand Met retained Swander, Pace and Company as food industry consultants to assist in evaluating the assets of Pillsbury.

b. On or about June 20, 1988, Grand Met retained S. G. Warburg and Co., Inc., and S. G. Warburg and Co., Ltd., to act as financial advisors on the proposed tender offer.

c. On or about June 30, 1988, Grand Met retained Morgan Stanley as a financial advisor.

d. On or about July 12, 1988, Grand Met retained Cravath as special United States counsel.

e. On or about July 18, 1988, Grand Met retained Dorsey and Whitney as Minnesota counsel to provide legal services in connection with its tender offer for Pillsbury common stock.

f. On or about August 16, 1988, Grand Met's board of directors approved the acquisition of all outstanding common stock of Pillsbury by means of a tender offer.

g. On or about August 18, 1988, financing for Grand Met's proposed tender offer was established.

3. On or about the dates set forth in Counts 38 through 54, in the State and District of Minnesota and elsewhere, the defendant,

as part of the aforesaid scheme and artifice to defraud, knowingly and willfully engaged in fraudulent, deceptive and manipulative acts and practices in connection with a tender offer, namely, Grand Met's tender offer for Pillsbury common stock, in that, after Grand Met had taken a substantial step to commence a tender offer for Pillsbury common stock and while in possession of material information relating to such tender offer, which information he knew to be non-public and which he knew had been acquired directly and indirectly from (1) the offeror, Grand Met, and (2) a person acting on behalf of Grand Met, namely, Thomas Tinkham, he purchased and caused to be purchased Pillsbury common stock and call options on Pillsbury common stock without public disclosure first being made by press release and otherwise of the information he had obtained, together with the source of such information, within a reasonable time prior to the purchases set forth below:

COUNT	APPROXIMATE DATE	TYPE OF SECURITY	AMOUNT PURCHASED	BROKERAGE FIRM
38	August 29, 1988	October 40 Call Options	100 Option Contracts	Robinson-Humphrey

COUNT	APPROXIMATE DATE	TYPE OF SECURITY	AMOUNT PURCHASED	BROKERAGE FIRM
39	August 30, 1988	October 40 Call Options	100 Option Contracts	Robinson-Humphrey
40	August 30, 1988	November 45 Call Options	50 Option Contracts	Janney Montgomery Scott
41	August 31, 1988	October 40 Call Options	100 Option Contracts	Robinson-Humphrey
42	September 1, 1988	October 40 Call Options	300 Option Contracts	Robinson-Humphrey
43	September 2, 1988	October 40 Call Options	222 Option Contracts	Robinson-Humphrey
44	September 6, 1988	October 40 Call Options	200 Option Contracts	Robinson-Humphrey
45	September 7, 1988	October 40 Call Options	278 Option Contracts	Robinson-Humphrey
46	September 8, 1988	October 40 Call Options	300 Option Contracts	Robinson-Humphrey
47	September 8, 1988	November 45 Call Options	50 Option Contracts	Janney Montgomery Scott
48	September 9, 1988	October 40 Call Options	202 Option Contracts	Robinson-Humphrey
49	September 12, 1988	October 40 Call Options	198 Option Contracts	Robinson-Humphrey
50	September 19, 1988	November 40 Call Options	100 Option Contracts	Robinson-Humphrey
51	September 20, 1988	November 40 Call Options	75 Option Contracts	Robinson-Humphrey
52	September 20, 1988	October 45 Call Options	100 Option Contracts	Robinson-Humphrey
53	September 20, 1988	Common Stock	5,000 Shares	Dean Witter Reynolds
54	September 21, 1988	November 40 Call Options	125 Option Contracts	Robinson-Humphrey

All in violation of Title 15, United States Code, Sections 78n(e) and 78ff(a), and Title 17, Code of Federal Regulations, Section 240.14e-3(a).

MONEY LAUNDERING
COUNT 55

1. The grand jury realleges and incorporates by reference paragraphs 1 through 19 of this indictment and Counts 1 through 54 of this indictment as if fully set forth herein.

2. On or about October 5, 1988, in the State and District of Minnesota and elsewhere within the United States, the defendant,

JAMES HERMAN O'HAGAN,

did knowingly and willfully engage and attempt to engage in a monetary transaction, affecting interstate and foreign commerce, in criminally derived property of a value greater than $10,000, that is, the transfer by wire of funds approximating $2 million, such property having been derived from a specified unlawful activity, that is, mail fraud and fraud in the sale of securities; all in violation of Title 18, United States Code, Section 1957.

MONEY LAUNDERING
COUNT 56

1. The grand jury realleges and incorporates by reference paragraphs 1 through 19 of this indictment and Counts 1 through 54 of this indictment as if fully set forth herein.

2. On or about October 6, 1988, in the State and District of Minnesota, the defendant,

JAMES HERMAN O'HAGAN,

did knowingly and willfully conduct and attempt to conduct a financial transaction involving the use of a financial institution which was then engaged in, and the activities of which affected, interstate and foreign commerce, in that, defendant obtained from First Bank a cashier's check in the approximate amount of $380,736.59 to replace the Northrup King client trust funds he had previously embezzled and converted, which sum of approximately $380,736.59 involved the proceeds of a specified unlawful activity, that is, mail fraud and fraud in the sale of securities, knowing that the transaction was designed in whole and in part to conceal and disguise the nature and source of the proceeds of said specified unlawful activity and that while conducting and attempting to conduct such financial transaction the defendant knew that the property involved in the financial transaction, that is, funds in the amount of approximately $380,736.59, represented the proceeds of some form of unlawful activity, namely, mail fraud and fraud in the sale of securities; all in violation of Title 18, United States Code, Section 1956(a)(1)(B)(i).

MONEY LAUNDERING
COUNT 57

1. The grand jury realleges and incorporates by reference paragraphs 1 through 19 of this indictment and Counts 1 through 54 of this indictment as if fully set forth herein.

2. On or about October 6, 1988, in the State and District of Minnesota, the defendant,

JAMES HERMAN O'HAGAN,

did knowingly and willfully conduct and attempt to con-

duct a financial transaction involving the use of a financial institution which was then engaged in, and the activities of which affected, interstate and foreign commerce, in that, defendant obtained from First Bank a cashier's check in the amount of approximately $70,000 to replace the Northrup King and Mayo Clinic client trust funds he had previously embezzled and converted, which sum of approximately $70,000 involved the proceeds of a specified unlawful activity, that is, mail fraud and fraud in the sale of securities, knowing that the transaction was designed in whole and in part to conceal and disguise the nature and source of the proceeds of said specified unlawful activity and that while conducting and attempting to conduct such financial transaction the defendant knew that the property involved in the financial transaction, that is, funds in the amount of approximately $70,000, represented the proceeds of some form of unlawful activity, namely, mail fraud and fraud in the sale of securities; all in violation of Title 18, United States Code, Section 1956(a)(1)(B)(i).

FORFEITURE

1. The grand jury realleges and incorporates by reference paragraphs 1 through 19 of this Indictment and Count 55 as if fully set forth herein.

2. The defendant JAMES HERMAN O'HAGAN did knowingly and willfully engage and attempt to engage in a monetary transaction, affecting interstate and foreign commerce, in criminally derived property of a value greater than $10,000, that is, the transfer by wire of funds approximating $2 million, such funds having been derived from a specified unlawful activity, namely, mail fraud and fraud in the sale of securities, in violation of Title 18, United States Code, Section 1957. As a result of the foregoing offense, defendant JAMES HERMAN O'HAGAN shall forfeit to the United States all property, real and personal, involved in the aforestated offense and all property traceable to such property, including but not limited to the approximate amount of $2 million in United States currency and all interest and proceeds traceable thereto, in that such sum in aggregate is property which was involved in the aforestated offense and is traceable to such property, in violation of Title 18, United States Code, Section 1957, pursuant to Title 18, United States Code, Section 982(a).

3. If any of the property described in paragraph 2 above, namely the approximate amount of $2 million, as a result of any act and any omission committed by the defendant —

(a) cannot be located upon the exercise of due diligence;

(b) has been transferred or sold to, or deposited with, a third party;

(c) has been placed beyond the jurisdiction of the court;

(d) has been substantially diminished in value; and

(e) has been commingled with other property which cannot be divided without difficulty;

the United States is entitled to forfeiture of any other property of defendant JAMES HERMAN O'HAGAN up to the value of $2 million as described in paragraph 2 above, pursuant to Title 21, United States Code, Section 853(p).

A TRUE BILL

UNITED STATES ATTORNEY FOREPERSON

GOVERNMENT EXHIBIT 53
DORSEY & WHITNEY CONFIDENTIALITY POLICY

05-1-85

A. Confidentiality Statement

Lawyers are fiduciaries, meaning that their relations with their clients are based upon trust and confidence. Lawyers represent the interests of each of their clients to the utmost of their ability, and do not use their position of trust and confidence to further anyone's private interests.

A lawyer never discusses a client's business with outsiders, but considers it strictly confidential.

So sacred is the relationship between lawyer and client that information given to a lawyer by a client is a "privileged communication" — that is, the lawyer cannot be compelled to testify about it, and its unauthorized disclosure is unlawful. Some information to which our office has access is protected by court order; improper disclosure of such material would be punishable by contempt proceedings. Other information may be valuable as a trade secret; disclosure would cause substantial financial loss to a client.

A lawyer's responsibility to keep a client's confidences extends to all employees.

The need for confidentiality of information cannot be overemphasized. *It is highly improper for office personnel to discuss a case outside the office, even with members of their immediate families.* Irreparable harm can result from discussion of a client's affairs, even if no names are mentioned. Unauthorized communication by non-lawyer personnel may properly be regarded as grounds for discipline or dismissal.

It has always been the Firm's policy to enforce strict confidentiality of the affairs of its clients.

In order to preserve the security of files and information, the following rules are to be observed:

1. Information in office files shall *never* be disclosed except upon express authorization from one of the lawyers concerned with the matter or, in the absence of such lawyer, express authorization from another lawyer in the office.
2. Documents, files, securities, abstracts or other valuables held by the office may be given only to persons who are properly identified or vouched for, and then only in return for a signed receipt and only when authorized by one of the lawyers handling the matter or, in the absence of such lawyer, by another lawyer in the office.
3. During a lawyer's absence, no one shall be admitted to his or her office without prior notification being given to the lawyer's secretary so that papers on the desk and in the office may be removed or covered; or, if the secretary is absent from the office as well, another secretary should first check the lawyer's office and remove cover any papers.
4. At the request of the responsible lawyer, all confidential papers will be destroyed when no longer needed.
5. One client's business is never to be discussed with another client; as a general policy, it is best never to mention a client's name to anyone.
6. All Firm personnel have been informed of the following Firm policy and procedure with respect to investments in securities of publicly held clients — that is, clients whose commercial paper is publicly

available for purchase. All new employees are specifically so informed by our Personnel Department as a separate point of information during their orientation.

Investment in Securities of Publicly Held Clients

In order to further ensure the confidentiality of certain information concerning clients, the Firm has established policies and procedures to prevent the use of confidential information in connection with purchasing or selling securities of our clients. A reminder of this obligation is embodied in the following release of the Securities and Exchange Commission issued in April, 1977:

"SECURITIES EXCHANGE ACT OF 1934
"Release No. 1343/April 8, 1977

"Insider Trading by Law Firm Employees

"The nature of the services performed by law firms on behalf of their clients whose securities are publicly traded or who deal in such securities often results in those law firms receiving information which has not yet been released to the public but which is of great significance to the securities markets. The antifraud provisions of the Federal securities law, as well as the high ethical standards required of those engaged in the practice of law, mandate that the confidentiality of non-public information be preserved and in particular that such information not be used as the basis for trading in securities. This obligation extends not only to partners in the law firm but also to associated lawyers and service personnel employed by the Firm.

"It has come to the attention of the Commission that in certain instances law firm personnel (1) may have abused their position of trust and confidence by trad-

ing in securities while in possession of material nonpublic information obtained in the course of their employment, or by revealing such information to others who have engaged in securities transactions on the basis of such information.

"Law firms, like others which have confidential information in their possession that may affect the securities trading markets, have an affirmative obligation to safeguard such information.

"While the Commission recognizes that no procedures can guarantee that individual employees will not take unfair advantage of their position, law firms are encouraged to establish policies and procedures regarding confidential information and take steps to ensure that all firm personnel are familiar with those policies, including the serious consequences that may result from conduct violating such policies.

"By the Commission.

George A. Fitzsimmons
Secretary"

05-1-85

"(1) In these instances, the personnel involved were legal secretaries and stenotypists who had access to confidential communications from clients of the firm."

IT HAS ALWAYS BEEN THE POLICY OF THE FIRM TO FORBID THE UTILIZATION OR APPEARANCE OF THE UTILIZATION OF INSIDE INFORMATION OF PUBLICLY-HELD CLIENTS BY LAWYERS OR SUPPORT STAFF PERSONNEL OF THE FIRM OR THE TIPPING OF ANY SUCH INFORMATION TO OTHERS.

As indicated in the SEC release reprinted above, the use of such inside information or the tipping of such inside information to others violates both federal and state securities laws and can result in action by governmental agencies against the Firm as well as against the individuals involved. Even where inside information was, in fact, *not* utilized by the individual buying or selling a security, the possession of inside information by other persons in the Firm may lead to the *appearance* that such inside information was made available to the individual who bought or sold the security. False appearances regarding the utilization of inside information can be as damaging to the Firm as the actual utilization of such information.

Procedures

In view of the foregoing, the following procedures are established by the Firm with respect to the personnel of the Firm (both lawyers and support staff) buying or selling securities of publicly-held clients:

> *No lawyers or support staff personnel of the Firm (or the spouses or minor children of such personnel) may buy or sell securities of a publicly-held client of the Firm without first consulting the billing lawyer for that client to determine whether the Firm possesses material non-public information about the client which makes such trading inadvisable.* If advised that such information exists, the person must delay trading in the securities of that client until advised by the billing lawyer that the information has been made public. The term "publicly-held client" refers to publicly-held corporations or other publicly-held entities (including municipalities which issue bonds or other securities to the public) which we represent generally or which we represent in connection with their securities work.

Partners and associates are also reminded of the provisions of Section 13.10 of the Lawyers' Policy Manual, which requires advance approval by the Professional Personnel Committee of certain investments in or with clients, except where the investment is made through a broker in a regular market transaction.

Implementation and Demonstration of Compliance

Any lawyer or support staff personnel of the Firm should, prior to buying or selling a security of a publicly-held company, check with the File Room to determine whether the publicly-held company is a client of the Firm. If the publicly-held company is a client of the Firm, the person should then consult the billing lawyer for that client to determine whether the Firm possesses material non-public information about the client which makes trading inadvisable.

GOVERNMENT EXHIBIT 56

DORSEY & WHITNEY

NEW FILE REQUISITION

CHECK EACH ITEM WHICH IS APPLICABLE TO THIS FILE:

File Type		Bundle Type		File Folder Type		Forms Required/Attached*	
X	Standard Client/Matter	X	Correspondence	X	Red Rope	X	New Client Screening Form
	Computer Number Only		Legal		Manilla Expandex		Litigation Screening Form
	Office Account				Manilla Pocket		Conflict Check Report
	Trust File (Enter "P" & "T" #'s)				No Folder		FARA (Not attached)**
	Bond File (Enter "C" No.)						FLRA (Not attached)**

**No registration under the Foreign Agents Registration Act (FARA) or Federal Regulation of Lobbying Act (FRLA) required

CLIENT/MATTER INFORMATION

*Client Name: Cravath, Swaine & Moore
Bill Name: (same)
Street Address: One Chase Manhattan Plaza
City, State, ZIP: New York, NY 10005
*Client No: 151630
#4

*Matter Title: General
Description of Work: General Matters
Matter No: 5
*Area of Law:
Billing Matter Title (Provide when time will not be billed to this new matter.)
*Area of Law Code:
Billing Matter No:
*Billing Attorney: Peter Dorsey
Initials: PD
*Number: 0151
*Attorney in Charge: Thomas Tinkham
Initials: TT
Number: 0330
Department: Trial
Department Code: 03
Office: Hp&c
Office Code: 01
Others directly associated time to this matter: Michael Sweeney

BILLING INFORMATION

Send Bills To: Alan Parker
Street Address: Cravath, Swaine & Moore
City, State, ZIP: One Chase Manhattan Plaza
Special Billing Instructions: New York, NewYork 10005

FEE TYPE			
X	Regular		Allowed by Court
	Reginer		Special Rate
	Contingent		Pro Bono

*CONFLICT CHECK INFORMATION

Attorney Requesting Check:
Check No: 16000

List of known persons, businesses or other entities who are (or may come to be) involved in this matter. Also list (briefly) the relationship each has to our client: e.g., subsidiary, officer, family member, adverse party, etc. If you have a litigation matter, all adverse parties must be listed.

Name Codes
01. Client
02. Client (A/K/A or D/B/A)
03. Client (If formerly Known As)
04. Client (More Information Fol)
05. Adverse Party (Actual or Potential)
06. Certainty (Actual or Potential)
07. Non-Client Party to Transaction
08. Parent Company
09. Business Affiliate — Subsidiary/Division
10. Majority Stockholder
11. Officer/Director
12. Member (A/K/A or D/B/A)
13. Spouse (If formerly Known As)
14. Family Member
15. Trust/Estate

Name | Code

THIS MATTER HAS BEEN CLEARED WITH ROBERT STRUYK

This work approved? Yes No If work not approved, explain how they were resolved:

Signature: Tom Tinkham
*Billing Attorney:
*Approving Partner:
All of the names found have been checked against Dorsey conflict reports.
Said Oasis
Date File Opened: 9/4/89

NOTE: Information with asterisk is Required

BILLING

GOVERNMENT EXHIBIT 56 97-319

DORSEY & WHITNEY
CLIENT SCREENING FORM

This form must be completed for each new client. It is not necessary to complete this form for existing clients. Representation of a new client cannot be accepted until this form is completed, reviewed and approved. The Records Center will not assign a new client number without an approved form. All items must be completed. Conflicts must be checked before this form is submitted. The completed form should be sent to Mr. Strunk.

Client name: Cravath, Swaine & Moore

Client address: One Chase Manhattan Plaza
New York, NY 10005

Attn: _____

State of incorporation/residence: _____

Client is: ☐ Individual ☐ Corporation ☐ Trust
☒ Partnership ☐ Sole Proprietorship ☐ Cooperative
☐ Political Subdivision ☐ Other: _____

List client affiliations or relationships with other clients of the firm: _____

Description of client's business: Law firm

Is client publicly held? Yes ___ No X If so, please request a copy of its latest annual report.

If this is a going business, approximate annual revenues and number of employees: _____

List the key contacts at client: Alan Parker

If a corporation, list officers and directors: _____

Name of present/former attorney: _____ Name of accountant: _____

Explain in detail the subject matter/scope of proposed representation:
General matters

List business references, if available: _____

Did you discuss fees and is the client able to pay? yes How much of a retainer is the client willing to pay? _____

Do we expect billings to be in excess of $1,000 annually? _____

Describe other potential matters we can expect from this client: _____

Please provide the following information if this was a referral: _____

Name of person referring person _____
Name of firm _____
Street address _____
City, state and zip code _____

Do you perceive any unusual risk in the representation of this client? No

Why do you believe we should represent this client? _____

Provide any additional information that would be useful in serving this client: _____

WSW Business Profile (attached)

Date: 2/29/88

Approved: _____
Signature Partner

ms

SEND TO: TERRY KEARNS
(16W)

WRITE-OFF REQUEST
for
Unbilled Time and Disbursements
(WITH Recorded Billing Memo attached)

TO: ACCOUNTING - In Duplicate

FROM: Peter Dorsey

DATE: October 6, 1988

Client and Matter Names: Cravath, Swaine & Moore — General

Client and Matter Numbers: 151680 — 5

____ Total write-off is $1000 or less of unbilled time and disbursements.

$_____ unbilled time $_____ unbilled disbursements

_____
Signature of Billing Attorney

_____
Signature of Partner Approving Associate/Staff Attorney's Write-Off Request

---

____ Total Write-off is $1,001 to $5,000 of unbilled time and disbursements.

$_____ unbilled time $_____ unbilled disbursements

REASON:

_____
Signature of Billing Attorney

AND

_____
Signature of Billing Review Partner

XX Total write-off is $5,001 to $25,000 of unbilled time and disbursements.

$ 13,628.80 unbilled time $ 647.23 unbilled disbursements

REASON:

After becoming preliminarily involved in this matter, we decided to withdraw and, therefore, are not in a position to bill the fees or disbursements incurred prior to our withdrawal. (Additional time and disbursements also be written off).

Signature of Billing Attorney

Signature of Billing Review Partner J.O'Hagan

Signature of Department Group Head J.Levine

___ Total write-off request is over $25,001 of unbilled time.

$_____ unbilled time $_____ unbilled disbursements

REASON:

21804
#21315T
T= 13 628.80
D= 647.23

Signature of Billing Attorney

Signature of Billing Review Partner

Signature of Department Group Head

Requires Finance Committee Approval

GOVERNMENT EXHIBIT 75
(O'HAGAN DEPOSITION TRANSCRIPT)

[80]

Q. What precipitated your renewed interest in Pillsbury in July?

A. As I recall Bill Parks called me and said that, you know, there was a rumor that someone is accumulating Pillsbury, and he said it is all over the tape that it's Beatrice Company, and he said — you know, I may have talked to Bill Parks in March. I don't remember, but, you know — but as I remember he is the first one in July that specifically brought it up again with me.

Q. And did he recommend that you buy at that time?

A. I don't' I remember if he recommended a buy but — well, certainly any time he tells me anything he is sort of recommending that I buy it, but I don't remember him specifically saying to buy some amount, but I think he told me to take a look at it.

Q. And what did you do to take a look at it?

A. I asked Stewart about it. I think I asked Considine about it too, you know. I don't specifically recall, but I'm sure I did.

Q. Just so I understand what Mr. Parks said, when you say "all over the tape", what did you understand him to [81] mean by that?

A. He had a research report on the tape or there is rumors on the tape. I think, you know, I actually had something from Parks that I think he gave me, you know, that said, you know, you know, statements like "Pillsbury is up a point today on rumors Beatrice is going to buy them", and then there is something on the

tape saying "Pillsbury is a takeover candidate with a value of 50 to 54". I think a specific statement, I don't remember by whom, to the effect that Pillsbury is the most logical candidate in the food industry, and if there is going to be any merger in the food industry, Pillsbury is it.

Q. And you remember seeing this in document form?

A. I remember he gave something to me.

Q. Mr. Parks did?

A. Yeah. If he didn't give something to me, he certainly talked about it, I mean.

Q. And you have a recollection specifically that the rumored bidder was Beatrice?

A. Oh, yes, absolutely. I mean that was on the tape.

[83] * * * * *

Q. What happened when you talked to Stewart?

A. Stewart said "I'll check it out".

Q. And what happened when he checked it out?

A. As I recall the next morning Stewart called me and said "You've got to buy some Pillsbury".

Q. And did he tell you what basis he had for thinking you should buy Pillsbury?

A. Yeah, he says I think that this is, you know, a viable rumor.

Q. I'm sorry?

[84]

A. A viable rumor.

Q. Did he tell you what, if anything, he did to check that out?

A. I don't recall if he said.

Q. Do you remember anything else about the discussion aside from the recommendation itself?

A. He said "You ought to buy 5,000 shares". I said, "Have I got enough money for that?" And he said I did and next I remember is he — I don't think he called me back. I think Janice called me back and told me what the price was.

Q. Do you remember what the price was?

A. No, I don't. It's on the statement.

[89] * * * * *

Q. That's right. The ones for which you have the account statements before you.

Before we went off the record we were discussing the circumstances leading up to the first purchase of Pillsbury. What was the date of that purchase?

(Pause.)

A. Settlement date was August 3 which means that trade date has probably July 27 assuming normal five business days.

[104] * * * * *

Q. When was the next time that you had a discussion with anybody about Pillsbury?

A. To the best of my recollection the next time I had a discussion with anybody about Pillsbury would have been on August 17th.

Q. And what makes you say August 17th as the date?

A. I remember specific. It was the day before I bought the calls.

Q. I see.

[105]

A. Now I'm not saying that I didn't talk to Parks or somebody or, you know, about Pillsbury in between, but the next time I specifically remember something.

Q. Um-hum. Well, do you remember between the time that you sold and the time that you recall considering buying again, do you remember hearing anything else about Pillsbury?

A. I do not.

Q. What happened on the 17th?

A. I was having a conversation with Jim Considine and, as I testified to earlier, he is an institutional broker for Montgomery, and his territory is England. His customers are England and Scotland as I understand it. He is free to call on any institution in England or Scotland or something. And he told me, he said, "Have you heard the new rumor on Pillsbury?" And I said "no". He said, "Well, there is a new rumor that a company in London or England, I've forgotten what he said, by the name of Grand Met or Grand Metropolitan may be interested in acquiring Pillsbury", and he said the rumor makes some sense. He said go back and look at the *Wall Street Journal* of last Friday and there is an article in there on Grand Met, and that article talks about them selling their hotels and the speculation is that they may use the money to buy a branded food or drink company.

Q. Did he say anything else?

A. That's all I can remember him saying.

[125] * * * * *

BY MR. DETORE:

Q. What was the next conversation you recall concerning Pillsbury that you had with anybody after the purchases on the 18th?

[126]

A. I had a conversation with Mr. Considine that day.

Q. And what happened in that conversation?

A. My recollection is that I called him around noon or thereabouts and talked to his — I guess it's his sales assistant.

Q. And what is his sales assistant's name?

A. I can't remember. His secretary, whatever. And she said Jim was having — too busy to talk to me or something to that effect, and I called him back after the close and I talked to him about Pillsbury.

Q. You talked to him about what?

A. I talked to Mr. Considine after the close about Pillsbury.

Q. And what did he say?

A. I'm not sure whether he — it was in this conversation or a subsequent conversation, but he told me that he had had his biggest day ever, and that he had a customer buy 250,000 shares of Pillsbury, and that he had had some problems in filling the order. He had bought a little bit at 36 1/8th, a little bit at 36 5/8ths, and he bought a couple hundred thousand shares at 37, and that then the specialists had taken the stock down and closed it at 36 1/4.

Q. Did he identify who the customer was?

A. No. And this conversation may have been the next day too. I don't recall whether it was that day specifically. [127] I think it was that day.

[128] * * * * *

Q. What was the next conversation you had with anyone concerning Pillsbury after the conversation with Mr. Considine?

A. The next morning I recall having a conversation with Ms. Kinnahan.

Q. Who initiated that conversation?

A. I think I was out of the office in St. Paul or something, and I think she called the office and left a message, and I called her back.

Q. And —

A. That's my best recollection.

Q. And what did you say and what did she say?

[129]

A. She said, you rumor on Pillsbury wasn't a rumor. She said, you know, this company in England announced that they were interested in acquiring Pillsbury, and she said, isn't it in the Minneapolis papers? She kind of has the impression that Minneapolis is in the hinterland someplace. And I said, I don't know, I didn't see it in the paper this morning. I said, who told you they announced it? She said, I saw it on Dan Dorfman's show last night. I said, well, you know, Dorfman really talks about rumors, doesn't he? And she said, this wasn't a rumor, it was an announcement.

Q. Did anything else transpire in the conversation?

A. Not that I recall.

Q. Did you tell her that you had purchased Pillsbury options?

A. You mean the day before?

Q. No, on this occasion — you had told her the day before?

A. I don't recall whether I told her or not.

Q. Do you remember whether you —

A. At some point I told her I purchased some Pillsbury options, but I don't remember when I did.

Q. What, if anything, did you do after that conversation?

A. I called Janice and told her to buy another 100 calls.

[130]

Q. When you — how long after you talked with Ms. Kinnahan did you call Janice?

A. I don't — quite candidly, my recollection is I called Janice before I talked to Ms. Kinnahan. I really bought the calls based upon what Considine had told me.

Q. Did anything happen between the 18th and the 19th that caused you to make, you know, the second 100 purchase?

A. Yeah, he had told me that a customer bought 250,000 shares.

Q. Oh, I see. I thought you said that was after the conversation with —

A. No.

Q. Is there more than one conversation with — the conversation with Mr. Considine about the 250,000 took place after the close, as I understand?

A. Yes.

Q. And then you are not certain whether the conversation with Ms. Kinnahan was before or after the order?

A. I'm not certain. It may have been after the order. I remember being very surprised that, you know, she told me the company had announced that they were acquiring Pillsbury or considering acquiring Pillsbury.

[133] * * * * *

Q. What happened?

A. As to the debate, you mean?

Q. That's right.

A. Stewart returned from vacation on Monday and some time on Monday I talked to him, and he said, I see you bought a couple hundred calls. He said, did you buy them on the Kelly rumor or on the Dorfman rumor? And I said, what the hell is the Kelly rumor? And he said, there is a rumor that — I hadn't heard of Kelly. Kelly apparently is chairman or something of Beatrice. And he said, there is a strong rumor that Kelly is going to announce something on Pillsbury soon, and I said, what is the Dorfman rumor? And he said, one of my customers told me that Dorfman had talked about some British company last week. And so I said, well, my broker in Washington tells me that it was a company announcement. And as I remember, Stewart saying, I don't know, my customer told me it was a rumor. And that is what the debate was.

[140] * * * * *

Q. What was the next time you learned anything new concerning the rumor in Pillsbury?

A. Which rumor?

Q. The rumor we are discussing now concerning Grand Met.

A. Well, on Monday I talked to Stewart and he asked me whether I had bought the calls, the earlier calls, on the basis of the Kelly rumor or the Dorfman rumor, and then he went [141] on to say, you know, that he had good information that Kelly was going to do something near term and that we ought to buy some more Pillsbury.

Q. Did he elaborate in any way on, first of all, what the source of his information was concerning Kelly?

A. No.

Q. Did he elaborate in any way on the issue of what the near future meant?

A. On the near future, soon.

Q. Did he make a recommendation concerning a purchase to you at that time?

A. Yes .

Q. And what did he say?

A. "Why don't you buy some more calls".

MR. BRAVERMAN: Did he express a view with regard to the Grand Met rumor?

THE WITNESS: Yeah, he kind of discounted it.

BY MR. DETORE:

Q. Did he tell you why?

A. He said, well, I don't know anything about it. It's a Dorfman, but he said — he said it could be — he said it could be helpful, and he said, it probably has flushed Kelly out. I said, what do you mean? He said, well, you know, you get this out that England announcing they are interested in acquiring Pillsbury is going to force Kelly's hand, which I [142] think is what his rationale was, whether there was going to be an announcement soon.

Q. And did you make purchases as a result of the recommendation he made that day?

A. Yeah, we bought a hundred calls on Monday.

MR. BRAVERMAN: That is Monday, the 22nd of August?

THE WITNESS: Yes.

[143] * * * * *

Q. What was the next discussion that you recall having after you purchased the options on the 22nd concerning Pillsbury?

A. Well, I may have had — the next one I specifically remember concerning Pillsbury? The next day, true to Stewart's prediction, it was on the tape that Kelly was resigning from Beatrice and two of his people resigning with him, and that they were resigning apparently to put together a [144] bid and the reported target was Pillsbury.

[145] * * * * *

Q. As I understand it you had a conversation then on the 23rd in which you learned about the tape story on it, and then if I understand your testimony, it was the next day that you talked to Mr. Evans concerning it?

A. I remember him calling me, you know, early in the — relatively early in the morning, I guess, for me, 8:30 or something, and reading to me from the *Wall Street Journal.*

Q. Was anything else said during the conversation?

A. Yes, he says, I bought some Pillsbury stock for my own account and I think you ought to buy some. I mean he says, you really don't have much of a position. You got, you know, $15,000 position or something and you ought to buy some. He said, I bought 5,000 for my own account and I said, well, all right, go ahead and buy 5,000 Pillsbury. And he said — he talked about — he said, I think we ought to buy some more calls, and I said, all right, go ahead and buy a hundred.

Q. Did he give you any reason why he was recommending that you buy stock rather than calls in this instance? As I understand it he recommended that you buy both, but did he tell you why specifically stock?

[146]

A. All I remember him saying is, I just bought 5,000 shares for my own account, or I am going to, or I did, or whatever, and he says, why don't you buy 5,000. You know, that was a stock I'd had before.

* * * * *

[147]

Q. What was the next purchases of Pillsbury that you made?

A. The next day I had a conversation with Stewart and — a couple conversations. I had one conversation where he said, you know, your option is trading at 3/8ths and why don't we buy another hundred to average down

to a half, and I said, okay. And as I think I previously testified it takes about a week to get confirmations from Stewart, and I had another conversation with Stewart because I then had the confirmation of the first call I had bought, and I learned that the call expired in the middle of September, and I was under the impression it would expire at the end of September, and so I talked to Stewart and I said, God, I said, do you realized that these calls expired in the middle of September? And he said, yeah, that's why they are so cheap. And I said, yeah, I know, but — and he said — I said, oh, in addition I had read the *Wall Street Journal* article that Stewart was talking about and it said that Kelly wasn't going to resign until October 1st. And he said, say, you're right, you know. He said, we got to move these calls into October. And I said, there aren't any October. That's when we got — he said, what do you mean? I said, darn it, I mean I asked Janice about it and she didn't tell me about any Octobers. He says, yeah, there's Octobers.

And I said, well, I was unaware at the time that there were. And he said, well, in any event I think you ought [148] to — you ought to move these 500 calls into October, and he said, why don't you buy the — why don't we buy 500 October 35's, and I said, well, just a minute, how much money is that? And he said, probably $150,000. And I said, well — he said, well, you are up that much on, you know, on the year, and why don't, you know — he said, that's what I'm buying, or that's what I'm recommending or whatever. And I said, well, you'd better do a little analysis on the account and tell me how much I am up.

And so he called me back and said, year, you're up about 150. I said, well — he said, I think you ought to move and he said, don't worry about the Octobers. I think somebody else is — I mean about the Septembers.

Somebody else had told me this too. He said, you know, Pillsbury is a basket stock. On these program trading Pillsbury is one of the stocks they program trade, and he said, I think the market is going to move up here and I think the program trading will move Pillsbury up and we'll be able to get out of the — on a rally get out of the Septembers and let's buy — let's buy the October 35's while they are cheap. And I said, okay.

And I either talked to him that night or the next day and didn't buy any at 3, and I think it was the next day, which would have been Friday, I guess, he said, we can't buy any at 3. The price is 3 1/4, 3 1/2. He said, why don't we go to 3 1/2 to buy these things, you know. I said, you know, I just [149] think that's too much premium, Stewart, and he said, well, maybe you're right. Let's buy the 40's instead, and he said, you know, we could buy four times as many 40's, and he said we could buy the 40's at three quarters. And I said, well, okay, that seems like a — I said, I'm used to buying, you know, 40's. Go ahead.

Q. On the 25th —

A. The 25th is Friday now?

Q. No, the Friday I believe is the 26th. The 25th would be the Thursday. Did you purchase options on the 25th?

A. No. Oh, yeah, we purchased — we purchased 100 averaged out at 3/8ths.

[150] * * * * *

MR. BRAVERMAN: Let me just put the question to you. Prior to the time that you authorized or agreed with Stewart's recommendation of purchasing October 40's, did you have any conversation with anyone else about Pillsbury?

THE WITNESS: Yes, I did. I had a conversation — I probably had a conversation with Ms. Kinnahan, but I don't specifically recall, but I clearly had a conversation with Mr. Considine on, as I recall, the 24th.

MR. BRAVERMAN: Was that before or after the market close?

THE WITNESS: I think it was after the market closed.

BY MR. DETORE:

Q. And what did he say?

A. He said that he was going to buy some Pillsbury for his own account, and I said, did your customer who bought the 250,000 shares ever tell you why he bought the stock? And he said no. But he said, you know, it's now, whatever it was, four or five days, and Grand Met hasn't denied the rumor or statement, whatever it was, and they haven't clarified it, and so I'm buying some Pillsbury for my own account.

Q. Did he say how much?

A. No.

Q. Did he tell you anything else about the customer?

A. No. All I either know or I surmised was that it a, [151] you know, a London customer and, you know, just to kind of reiterate, he told me the rumor on the 17th about Grand Met and the London customer bought 250,000 shares at the market the next day, and Grand Met hadn't denied the statement or rumor, whatever it was, and I thought that was very significant information.

Q. Well, did you ask him whether the customer had been Grand Met?

A. Pardon me?

Q. Did you ask him whether his customer had been Grand Met?

A. Had been to Grand Met?

Q. Had been Grand Met.

A. Oh, no.

Q. Did you have the impression that it might have been?

A. It never occurred to me it was Grand Met. I thought it was an English bank, or you know, or English institution.

[153] * * * * *

Q. You testified that the Kelly rumor influenced Mr. Evans' recommendations. Did it influence your purchases?

A. Absolutely.

Q. And was that true through the remainder of the time that you were purchasing Pillsbury?

A. Yes, it did.

Q. How about the Dorfman — I'll call it a rumor even though you've stated that it read like more than a rumor — did that rumor influence your decision to purchase?

A. Absolutely.

Q. And did it continue to through the end of your purchases?

A. Well, the rumor and what Considine had told me. What Considine had told me was what primarily influenced me.

[154]

Q. — the Dorfman rumor continued to through the end of your purchases?

A. Well, the Dorfman rumor was initially of some concern because, you know, I was told, you know, if they deny it, you know, that ballgame is over and, you know, that they thought, you know — you know, I was told if that had been a United States company, they would have had to have said something.

Q. So beginning after you first heard that rumor —

A. But I mean by the time Considine told me, they hadn't denied it and, you know — so I thought, yeah, absolutely. In fact, you know, to be quite candid with you, it was sort of a public rumor in Minneapolis. I mean everybody was talking about some company in England was going to buy, you know, Pillsbury.

Q. When was that?

A. During that next week, you know, after the Dorfman.

Q. What gave you the impression that it was a public rumor in Minneapolis?

A. Oh, I don't know. All the brokers I talk to were talking about it. In fact, I heard a couple people in the [155] elevator one day talking about, "Say, did you hear that some outfit in England is thinking about taking on Pillsbury". We are in the Pillsbury Center, of course.

[156] * * * * *

MR. BRAVERMAN: Is it fair to say that it was the confluence of all of these rumors occurring at the same time that led you to the impression that Pillsbury was very much in play?

THE WITNESS: Yes, and I kept hearing this, you know, where there is smoke there's fire and, you know, Grand Met had flushed out Kelly and, you know, it appeared that way. I mean, you know, Grand Met's announcement on the 18th and, you know, five days later Kelly announces.

[157] * * * * *

Q. Following the conversation you've testified to concerning — with Mr. Considine concerning his own personal — what was the next time you had any discussion with anyone where you learned anything new about Pillsbury?

A. I talked to Considine as I remember on the 24th. I think we've gone over what happened on the 25th.

Q. Um-hum.

MR. BRAVERMAN: Those were the two conversations with Evans?

THE WITNESS: Yes. At least two. Maybe three. I know he figured the account, or at least he told me he did. Yeah, then the next time would have been on Friday, I guess.

BY MR. DETORE:

Q. And what happened then?

A. Stewart told me — well, I guess maybe we've been over this — that he hadn't bought any, you know, at 3 and he wanted to go to 3 1/2.

[158]

Q. This was the conversation which you revisited with him which series of options was appropriate to purchase?

A. Yes. I told him I though 3 1/2 was too much premium and he said, you're right, let's buy the 40's, and he said, you know, we can buy four times as much, and there was a little misunderstanding on that later on, but I said, go ahead and buy some 40's.

Q. Now if I understand Mr. Evans' original recommendation, he wanted you to buy 500 calls, is that correct, in the October 35?

A. October 35's at $3.

Q. And on — when was the next time you actually made a purchase?

A. On that Friday he was going to go ahead and buy 40's at three-quarters. He didn't buy any.

Q. How many had he planned to buy on that Friday?

A. I had understood he was going to buy 500, but as I said, there was a little misunderstanding on that which we clarified at a later date.

MR. MATHEWS: Why don't you explain the misunderstanding.

THE WITNESS: I thought he was going to buy 500. He had said to me, you know, we could buy four times as many. He thought he was then authorized to buy four times as many.

[159]

Q. So he had an understanding that you were authorizing him to buy 2,000?

A. Yes.

GOVERNMENT EXHIBIT 78

Date	Buy or Sell	Number of Shares or Option contracts	Price	Total	Profit	Percentage on Return	Annualized Percentage on Return
8/29/85	Buy	100 Oct. 40	75.000	7,500.000			
10/4/85	Sell	100 Oct. 40	1,812.500	181,250.000	173,750.000	2,317%	23,167%
8/30/85	Buy	50 Nov. 45	43.750	2,187.500			
10/4/85	Sell	50 Nov. 45	1,300.000	65,000.000	62,812.500	2,871%	29,533%
8/30/85	Buy	100 Oct. 40	75.000	7,500.000			
10/4/85	Sell	100 Oct. 40	1,812.500	181,250.000	173,750.000	2,317%	23,829%
8/31/85	Buy	100 Oct. 40	75.000	7,500.000			
10/4/85	Sell	100 Oct. 40	1,812.500	181,250.000	173,750.000	2,317%	24,529%
9/1/85	Buy	100 Oct. 40	62.500	6,250.000			
10/4/85	Sell	100 Oct. 40	1,812.500	181,250.000	175,000.000	2,800%	30,545%
9/1/85	Buy	200 Oct. 40	68.750	13,750.000			
10/4/85	Sell	200 Oct. 40	1,812.500	362,500.000	348,750.000	2,536%	27,669%
9/2/85	Buy	200 Oct. 40	75.000	15,000.000			
10/4/85	Sell	115 Oct. 40	1,812.500	208,437.500	199,812.500	2,317%	25,062%
10/5/85	Sell	85 Oct. 40	1,812.500	154,062.500	147,687.500	2,317%	25,272%
9/2/85	Buy	22 Oct. 40	62.500	1,375.000			
10/5/85	Sell	22 Oct. 40	1,812.500	39,875.000	38,500.000	2,800%	30,345%
9/6/85	Buy	200 Oct. 40	75.000	15,000.000			
10/5/85	Sell	200 Oct. 40	1,812.500	362,500.000	347,500.000	2,317%	28,759%
9/7/85	Buy	100 Oct. 40	81.250	8,125.000			
10/5/85	Sell	100 Oct. 40	1,812.500	181,250.000	173,125.000	2,131%	27,396%
9/9/85	Buy	170 Oct. 40	75.000	13,350.000			
10/5/85	Sell	170 Oct. 40	1,812.500	322,625.000	309,275.000	2,317%	30,809%
9/9/85	Buy	300 Oct. 40	93.750	28,125.000			
10/5/85	Sell	200 Oct. 40	1,812.500	362,500.000	343,750.000	1,833%	24,444%
10/17/85	Sell	100 Oct. 40	1,812.500	181,250.000	171,875.000	1,833%	14,925%
9/9/85	Buy	50 Nov. 45	56.250	2,812.500			
10/4/85	Sell	41 Nov. 45	1,312.500	53,812.500	51,506.250	2,233%	30,925%
10/4/85	Sell	9 Nov. 45	1,300.000	11,700.000	11,193.750	2,211%	30,619%
9/9/85	Buy	200 Oct. 40	87.500	17,500.000			
9/17/85	Sell	200 Oct. 40	1,812.500	362,500.000	345,000.000	1,971%	18,677%
9/9/85	Buy	2 Oct. 40	81.250	162.500			
9/12/85	Buy	198 Oct. 40	81.250	16,087.500			
9/17/85	Sell	100 Oct. 40	1,812.500	181,250.000	173,125.000	2,131%	21,852%
9/17/85	Sell	100 Oct. 40	1,837.500	183,750.000	175,625.000	2,162%	22,253%
9/10/85	Buy	97 Nov. 40	212.500	20,612.500			
9/10/85	Buy	3 Nov. 40	200.000	600.000			
10/4/85	Sell	100 Nov. 40	1,825.000	182,500.000	161,287.500	768%	10,240%
9/20/85	Buy	75 Nov. 40	200.000	15,000.000			
9/21/85	Buy	125 Nov. 40	225.000	28,125.000			
10/4/85	Sell	114 Nov. 40	1,825.000	208,050.000	164,275.000	775%	20,433%
10/5/85	Sell	86 Nov. 40	1,837.500	158,025.000	136,675.000	717%	18,429%
9/20/85	Buy	5,000 Shares	38.750	193,750.000			
10/4/85	Sell	5,000 Shares	58.375	291,875.000	98,125.000	51%	1,302%
9/20/85	Buy	100 Oct. 45	43.750	4,375.000			
10/4/85	Sell	100 Oct. 45	1,312.500	131,250.000	126,875.000	2,900%	34,579%
Total Profit					4,305,625.000		

DEFENDANT'S EXHIBIT 9

MERGERS & ACQUISITIONS WEEK

(Continued from page 13)

Michael Hoffman, managing director—co-head of M&A at Smith Barney, confirmed that Weitzel had resigned last week. However, he dismissed reports that he and co-head Bill Wagner were deeply upset at Weitzel's decision. "I think the correct response is to say that he had a good opportunity, he took it, and we wish him well," Hoffman said.

Sources said that when Weitzel resigned late Tuesday, he had been asked to clean out his office over the weekend rather than during office hours because his Smith Barney superiors didn't want co-workers to immediately learn of his resignation. But by late Thursday, his departure was being formally acknowledged at the firm.

Weitzel speaks Japanese and had worked in the corporate finance group at Dillon Read & Co. before joining Smith Barney. He is expected to make several hires in the next few months as Chemical continues to build its corporate finance group, a Chemical official said.

Beth Anton

investments

Grand Met's Speedy Auction Of Hotel Unit Raises Eyebrows

Grand Metropolitan PLC's request that all interested parties submit bids for its Intercontinental Hotels subsidiary within two weeks indicates that the U.K. company is in a rush to raise cash, several investment bankers said. The tight deadline that Morgan Stanley & Co. Grand Metropolitan's investment banker, has established for auctioning the hotel chain also signals the company's eagerness to follow through with its plans to buy a branded food processor for $5 billion to $6 billion.

Indeed, some investment bankers believed that the auction was just a formality and that Grand Metropolitan was already near an agreement to sell Intercontinental. One source said Morgan Stanley already had narrowed the potential buyers down to four candidates: The Robert M. Bass Group, Trusthouse Forte PLC, Nestle SA and SAS, the Scandinavian airline.

Determining Intercontinental's fair value, which some estimate at about $2.5 billion, is proving very difficult for some bidders, given the short time frame that they have to evaluate bids. "There are about 100 different hotels in 75 countries," said one investment banker. "It usually takes a few months to put together a bid on this kind of company because you have to figure out what the different properties are worth."

Grand Metropolitan's desire to raise cash quickly has fueled speculation that it will launch a bid for a major U.S. food company within the next month. Some analysts in the U.K. believe that the company has targeted Pillsbury, since the Minneapolis-based food processor and fast-food operator meets many of the criteria that Grand Metropolitan has stated it is seeking in an acquisition target.

Their hotel assets were not registering a very high rate of return; it was less than 4% on assets employed, one analyst in the U.K. said. "The branded food area is one where returns are larger and they know they would have had to invest capital in the hotel business to increase its profitability."

This analyst also noted that Grand Metropolitan has indicated it would be quite aggressive in selling off the assets of its target to pay down acquisition debt. The sale of Intercontinental could bring in $2.5 billion on top of the $700 million the company received when it sold its soft drinks business earlier this year.

One divestiture candidate at Pillsbury is its Burger King subsidiary, which has seen its profit margins come under increasing pressure in recent years. Despite its problems, investment bankers said the fast-food chain could generate tremendous interest if it was put up for sale.

Evan [illegible]

STRATEGIC FOCUS

Micom Systems Wants—Gets An Additional $10 Million

Micom Systems found a solid cash buyout bid from Odyssey Partners more attractive than a previous bid that was contingent on the divestiture of two divisions. Like earlier bidders, however, Odyssey will probably sell Micom's local area network business after the deal closes in order to finance the transaction.

Odyssey made its $16 per share tender offer for Micom two weeks ago. The $201.3 million proposal was $10 million higher than a joint offer made in July by Welsh, Carson, Anderson & Stowe IV and E.M. Warburg, Pincus & Co. [illegible]

The Welsh Carson/Warburg Pincus offer was made July 12 for 315.62 a Micom share. But their offer hinged on the sale of two Micom divisions, Micom-Interlan and Micom Digital Corp.

If these divisions had not been sold prior to the buyout, Micom shareholders would only have received $12 per share, plus the per-share equivalent of the proceeds when the units were sold. Micom allowed the buyout proposal to expire without acting on it and the offer was dropped.

Goldman, Sachs & Co. and Hyde & Covington are co-financial advisers to Micom, a supplier of networking communications equipment. Drexel Burnham Lambert acted as the financial adviser to Odyssey.

California-based Micom has already agreed to sell Micom Digital Corp., the wholly owned subsidiary of Micom, will be sold to Telemetrics International, a Florida-based communications company, for $9.6 million, a company official said.

Odyssey plans to sell another Micom business, Micom-Interlan, at some point after the buyout, a Micom official noted. Odyssey officials could not be reached for comment.

Odyssey will finance the acquisition through a bank facility with manufacturers Hanover Trust and debt and preferred stock offers placed through Drexel. Manufacturers Hanover will provide a $220 million senior bank facility for the tender offer.

This facility will be sub- [illegible]

removed after the merger through a $175 million line of senior debt financing, a spokesman of [illegible] said. The loan, an 18-month $50 million term loan and a revolving credit facility for up to $[illegible] million.

Drexel will provide up to $125 million through the sale of zero coupon [illegible] senior subordinated increasing rate notes, 250,000 shares of $25 million of senior increasing rate preferred stock, and $[illegible] million through junior preferred stock.

It is believed that these issues will be refinanced through the public or private placement of new debt and equity. Micom's management will also be participating in the buyout, a company official said.

[illegible]

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

FOURTH DIVISION

Criminal No. 4-92-219

UNITED STATES OF AMERICA, *PLAINTIFF,*

v.

JAMES HERMAN O'HAGAN, *DEFENDANT.*

Volume II-a
January 19, 1994

TRANSCRIPT OF PROCEEDINGS

HAD BEFORE THE HONORABLE
JAMES M. ROSENBAUM, and a Jury
Minneapolis, Minnesota

APPEARANCES:

For the Government	Christopher Bebel Jon Hopeman
For the Defendant	Charles Hawkins
Reported By:	Dawn M. Sampson, RPR-CM

* * * * *

[23] [GOVERNMENT OPENING STATEMENT]

Mr. Bebel:

Now, let's get back to the defendant's trading. How does the defendant get started in his purchases of Pillsbury? On July 27, 1988, the defendant buys 5,000 shares in Pillsbury. And on August 3rd, he sells. He locks in a small profit, about a $2 profit. He buys at 36, sells at about 38. Locks in a small profit, and he moves on. Holds for a short period of time, makes a little bit of money, and sells. Now, later on, he begins buying when he has inside information. That's a situation, end of July, beginning of August, where he's buying when there's no evidence that suggests he does have inside information. But later on he acquires inside information as to Pillsbury. And he starts then adhering to a different strategy. And [24] what's that different strategy? Well, at the end of August, he doesn't buy and sell, he just buys and buys and buys and buys. He starts buying on August 18th. And why is he accumulating? Because he has inside information. He has a secret. And because of that secret, he knows Pillsbury's going to be bought out.

[27] * * * * *

Now, the evidence shows that the defendant came and talked to Tinkham before this August 26 meeting while Tinkham's thinking about what he's going to be saying at this August 26th meeting, but there isn't going to be any evidence that shows the date at which he first came to know about the tender offer. The defendant comes in and shows that he knows prior to August 26, but there's going to be no evidence showing the first time at which he acquired the information. And so because he has to have the inside information in order for his trading to be illegal, no trades prior to

August 26 are charged in the indictment, although there were trades in Pillsbury prior to August 26. [28] There were trades on August — August 18th, August 21st, 22nd, et cetera. Those trades are not charged. Trades falling after August 26 are charged. Those trades begin August 26 and end September 21st.

* * * * *

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

FOURTH DIVISION

Criminal No. 4–92–219

UNITED STATES OF AMERICA, *PLAINTIFF,*

v.

JAMES HERMAN O'HAGAN, *DEFENDANT.*

Volume III
January 20, 1994

TRANSCRIPT OF PROCEEDINGS

HAD BEFORE THE HONORABLE
JAMES M. ROSENBAUM, and a Jury
Minneapolis, Minnesota

APPEARANCES:

For the Government	Christopher Bebel Jon Hopeman
For the Defendant	Charles Hawkins
Reported By:	Dawn M. Sampson, RPR-CM

* * * * *

[TESTIMONY OF J. JACKSON]

[Mr. Bebel:]

[94]

Q. And while you were working on these cases with the defendant, did you have any conversations relating to the law of securities fraud?

A. Quite often.

Q. And you had an opportunity to become familiar with the defendant's knowledge of that area of law?

[95]

A. Yes.

Q. And what did you observe in that respect?

A. I had learned the securities law in large part through my working with Jim, and I came to believe that he was probably the most knowledgeable person at the law firm in the area of securities fraud law, and was very knowledgeable.

Q. And did you also learn whether he was knowledgeable with respect to how markets worked, securities markets?

A. Yes.

Q. What did you learn in that regard?

A. That he was very knowledgeable.

Q. Did you ever have any conversations with him about how securities markets worked?

A. Yes.

Q. And how often did you have these conversations during the years you worked with him?

A. Oh, I don't know. I mean, they would tend to be case specific. So I can't really put an estimate. It was probably a handful at least.

Q. Well, did the defendant ever help familiarize you with efficient market principles?

A. I think it's better to put it this way: That we discussed on at least one if not more than one occasion what you refer to as efficient market principles.

[99] * * * * *

Q. Let's shift gears a little bit. At some point in 1988, were you aware of a tender offer being made for Pillsbury common stock?

A. Only after the fact.

Q. You were aware after the public announcement was made?

A. I read it in the newspaper.

Q. Well —

A. After the public announcement was made.

Q. Did you know that this announcement was going to be made prior to the time it was going to be made?

A. No.

Q. Did you have any in whatsoever?

[100]

A. Not I.

Q. And you were working at the Dorsey & Whitney law firm?

A. Yes.

Q. Did you have any knowledge as of the time the

tender offer announcement was made as to whether Dorsey & Whitney was representing the bidder who made the offer?

A. I was not aware of that.

Q. At that time?

A. At that time.

Q. And does October 4th, 1988, sound like the right date as to when this tender offer was made?

A. I would have to rely on you on that.

Q. Somewhere in the later half of 1988 though?

THE COURT: We'll assume it was October 4.

MR. BEBEL: Okay.

BY MR. BEBEL:

Q. And during this period, 1988, were you making in 1987 also, were you making any attempt to stay abreast of developments in the business sector, in local companies?

A. Oh, I think in general, yes.

Q. Well, what types of things were you doing to keep yourself aware?

A. I tried to just as a part of my practice since I work in [101] this community, keep abreast of general business information, particularly about local corporations, or about corporations that our firm either did represent or might in the future represent.

[102] * * * * *

Q. Now, Mr. Jackson, when we left off, I believe you had [103] testified that you had not been aware of the

tender offer for Pillsbury securities until that tender offer was announced?

A. That's correct.

Q. And you said that — there were times you were reading business publications to stay abreast of these developments?

A. General developments in the business community, right.

Q. Okay. I'm showing you what's been marked as Exhibit 60, and Exhibit 63. Both of these are Wall Street Journal articles, one comes from the Wall Street Journal dated December 22nd, 1987. The other is a Wall Street Journal article dated March 21st, 1988.

THE COURT: Just a second. That's Exhibit 6?

MR. BEBEL: 60. 60 and 63.

THE COURT: Okay. Thank you. I'm sorry, I just — I didn't have that.

BY MR. BEBEL:

Q. And 63 says Pillsbury's still vulnerable to takeover, analysts say. That's the Wall Street Journal article that comes from March of '88.

The other Wall Street Journal article says in there, Pillsbury has been mentioned among the domestic candidates for possible acquisition by an overseas giant such as Nestle. That's the Wall Street Journal article dated December 22nd, 1987.

[104]

Now, given publication of articles of that sort, how is it that you didn't know Pillsbury was going to be taken over?

MR. HAWKINS: Object. Calls for speculation.

THE COURT: You may answer.

THE WITNESS: My answer is is that there are articles published from time to time and particularly during this period of time, with great frequency, where people are speculating on takeover candidates.

BY MR. BEBEL:

Q. Was that true with respect to the food industry also?

A. Well, in my opinion, yes, I had specific familiarity with General Mills and they were touted in similar articles for being a takeover candidate as well.

Q. So you had some special interest in General Mills?

A. I did. They were one of my clients.

Q. And there were takeover articles about General Mills also?

A. I don't know to what frequency in comparison to Pillsbury, but there certainly were, yes.

Q. So then those articles didn't provide you knowledge of what was going to happen with respect to a tender offer?

A. Not to me, no.

[109] * * * * *

[MR. HAWKINS:]

Q. Now, Mr. Bebel asked you whether or not you were aware in your law firm while you were there of the potential for a tender offer being made against Pillsbury.

Do you recall [110] that?

A. I do.

Q. And you didn't learn about that till after the offer had been made, correct?

A. That's correct.

Q. Notwithstanding, you did not learn about the tender offer, there was an awful lot of talk in the office about Pillsbury, correct?

A. Not that I was aware of.

Q. Okay. There wasn't any conversation around town about the fact that Pillsbury was a target of a takeover by somebody someplace somewhere sometime?

A. Well, you're going to have to help me with what you mean by around town.

Q. Wasn't there a lot of speculation starting as early as late July in 1988 among the business community about what might happen to Pillsbury? If you know.

A. If you speak broadly, I think there's speculation about a lot of companies, given their financial circumstances. It's a publicly traded company, and therefore the public has access to a vast amount of information.

[TESTIMONY OF MICHAEL KENNEDY]

[122]

A. The first time that the acquisition happened, it required or made all of the analysts look at all of the companies in the food industry now, because it's sort of like when your house is sold in your neighborhood, it suddenly creates a value, a new value for the going price. And so once we saw the first acquisition, we looked at all of the companies within the food industry trying to find out what, given the newest price of the last transaction, what would all of these companies be worth.

And so once in the early '80s when that started, there was a list of companies, of food companies, that were potential takeover candidates, and Pillsbury was one of those.

Q. And you viewed Pillsbury as an attractive takeover target then beginning in the early '80s?

A. Yes.

Q. And you continued to view it as an attractive takeover candidate through what time period?

A. Well, it got taken over, so I guess '88: Off and on.

Q. Okay. Well, was there any period of time, say, from '82 to '88 where it was appearing less attractive as a takeover [123] candidate?

A. Yes, it was. Umm, the — the way I would go about it would be that I would identify what I thought the lowest price a stock company could get. And then what was its takeover value. So that gave me a range.

And at various times during this period the food stocks would move between these ranges, so I would be

buying the stock when it was low, but if it got up close to where I thought it was worth it to be taken over, then we would usually sell the stock. And that happened two or three times in Pillsbury.

* * * * *

Pillsbury had been saying for at least a year prior to [124] their taking over that they did not want to be taken over because the rumor kept running around about it. And so any takeover at Pillsbury was going to be unfriendly.

Q. Unfriendly?

A. Unfriendly. They didn't want — they wanted to stay independent. And a company can do certain things to try to keep someone from buying them. And Pillsbury, I think, umm, tried to do that.

Q. Tell us about that.

A. Well, there were two things they had going — well, going for them but against being taken over. One of them had to do with Burger King. Burger King, they owned Burger King, and Burger King had been a very poor performer. They were having a lot of trouble with their franchisees, they actually had rebellions with their franchisees, and that caused a lot of dissension. And if you're going to buy a company, you'd like to buy something that either you can fix or that isn't broken. And the potential of trying to take over Pills — Burger King and fix it, would be a very difficult task, particularly if you didn't have any restaurant background. So that was number one. The Burger King problem.

The second one is that they can make themselves what I call ugly. They went out and bought a tuna company in the summer of 1988. The tuna company was not

a good company. [125] It had been losing money. The industry itself, the tuna industry was not a good business, and so they were actually kind of making, in my mind they were trying to make themselves look even uglier so whoever had to buy them would have to pay for this tuna business, but they also have to try to sell it afterwards, and it was a big 4 — it was a $400 million company, so it was a big company.

Q. And so when Pillsbury then bought this tuna company in the summer of 1988, they were then making themselves less attractive takeover candidates?

A. In my opinion. And I put a sell out on our stock or our firm during that time.

[126] * * * * *

BY MR. BEBEL:

Q. Change that to Defendant's Exhibit Number 6. Do you recall being interviewed by a reporter with respect to Pillsbury takeover rumors in the beginning of October?

A. Ah, not really. During the last year of their existence, ah, I was interviewed quite a bit by the media because of, number one, even the national media, because I was located here, there was always questions about Pillsbury, so I don't, you know, I get interviewed a lot.

[128] * * * * *

And there's one other little piece to that is that, umm, if you have — Pillsbury also owned Steak and Ale and Bennigans. And they served liquor. Now, they were doing very poorly also. But it is also another item to keep them ugly. If you have any distribution, or you sell or make any alcoholic beverage, you cannot own a

restaurant that serves it, the alcoholic beverage. So that was another item that they had that companies could not be interested in Pillsbury if they were in the alcoholic beverage business themselves.

Q. Okay. Now I'm showing you a number of articles. One of them is Exhibit 66, which has been stipulated into evidence, Your Honor. It says that "Diet Doctor for the Dough Boy," references Pillsbury as being a possible takeover target.

Another article from Business Week, dated January 11th, 1988, says that Philip Morris is looking at Pillsbury.

By the way, this article that's titled a "Diet Doctor For The Dough Boy" is Business Week, and from August of 1988.

Another Business Week article from March of 1988, "Are Raiders Getting Hungry for Pillsbury?" And there's a couple [129] more of these articles.

Were you aware of articles of this sort during 1988 and prior to the takeover of Pillsbury?

A. Yes.

Q. And how is it that you were not aware of this tender offer prior to its announcement given the publication of those articles?

A. Well, there's a big difference. Umm, the analyst's job is to know the companies and know the industries, and to determine whether or not certain transactions like a takeover could, could happen, or who could be the target, who could be the one buying it. The newspapers are always having articles of rumors.

That's a big difference, a rumor's a big difference from

having the knowledge that the stock was going to be bought. The company was going to be bought. There's — that's — they're two different things.

* * * * *

[MR. HAWKINS:]

[139]

Q. Now, in that regard, you talked about the fact that with Pillsbury, they were involved in both the alcohol and [140] beverage industry, correct?

A. Alcohol and restaurant business, yes.

Q. And that if you're involved, for instance, in wholesale liquors, you might have a hard time taking over that business and keeping the restaurants and your alcohol business, correct?

A. You couldn't.

Q. Yet the analysts identified Grand Met as a potential takeover for that very reason about being able to break it up and get rid of the food and beverage, correct?

A. Ah, I — I can't agree with that because I don't — I didn't ever have Grand Met on my potential takeover of Pillsbury for just the reason of the alcohol. I don't know if someone else might have decided, ah, but they were not on my list of potential — it's usually a Nestle looking at or for —

* * * * *

BY MR. HAWKINS:

Q. We'll go to Government's Exhibit 68, all right, What is this, sir?

[141]

A. It's an article out of, umm, Investment Dealers Digest.

Q. What's the date on that?

A. August 22nd, 1988.

Q. When was the takeover of Pillsbury?

A. In October of '88.

Q. October 3rd or 4th?

A. Yeah, first week.

Q. So approximately six weeks or five weeks prior to the actual tender offer, roughly?

A. Three weeks.

Q. You've got the whole month of September. And part of August?

A. Right.

Q. Approximately five weeks?

A. Okay.

Q. Directing your attention to the, I guess right — to the yellow highlighted part at the end of the first paragraph in the article entitled "Grand Met Speedy Auction of Hotel Units Raises Eyebrows," would you read that highlighted portion to the jury, please, starting with Grand Metropolitan?

A. Grand Metropolitan investment banker, Metropolitan's investment banker has established for auctioning — I need my glasses, for auction the hotel chain. Also signals the company's eagerness to follow through with its plans to buy a [142] branded food processor for 6 billion to 8 billion.

Q. Five to six?

A. Five to six billion dollars.

Q. Okay. Now, Pillsbury eventually sold for five to six billion dollars, didn't it, 5.3 billion?

A. Yeah.

Q. Is that fair?

A. It's fair.

Q. Is Pillsbury a branded food processor?

A. Yes.

Q. Now, will you read the highlighted portion in the second column, unless you want me to, I mean, it's up to you, sir?

A. Okay.

Q. And maybe, Grand Metropolitan's desire to raise cash quickly has fueled speculation that it will launch a bid for a major U.S. food company within the next month. Some analysts in the United Kingdom, UK, believe that the company has targeted Pillsbury, since the Minneapolis based food processor and fast food operator meets many of the criteria that Grand Met has stated in seeking — it is seeking in an acquisition target?

A. That's what it says.

[147] * * * * *

Q. And in that regard, Government's Exhibit 65a is an article dated August 2nd, 1988, correct?

A. Correct.

Q. And it talks about Donald Trump buying Pillsbury in August of 1988, correct?

A. Buying stock in Pillsbury, yes.

Q. A lot of stock.

A. He's big and he's got a lot of money.

Q. He bought 2.5 million shares in seven days, correct?

A. That's what the article says, yes.

[151] * * * * *

Q. Well, August 2nd is the article that we just talked about with Donald Trump, fair? Is that right?

A. That's — I'll, the article is August 2nd.

Q. Right. That happens August 2nd?

A. Right.

Q. Now, during August we've already talked on August 22nd about Grand Met being identified as a potential takeover?

A. In that publication, yes.

Q. I'm showing you Defendant's Exhibit 10, which is an August 24th Wall Street Journal article. Correct?

A. Correct.

Q. Now, this identifies an individual by the name of Donald Kelly, correct?

A. Correct.

Q. And it identified — who was Donald Kelly?

A. Donald Kelly, umm, had at one point been the chairman of S–Mark, a Chicago based company. He was kind of known as a raider, an asset player.

Q. Involved with any major food companies?

A. Ah, yes, he got into a real dog fight with Beatrice. They tried to take each other over, and he was known for making hostile raids.

Q. Now, at least according to the August 24th, 1988 Wall Street Journal, Donald P. Kelly, in a move that may lead to his buying part of Beatrice Company resigned as chairman of [152] the company, along with two executives who could help manage his next acquisition vehicle, correct?

A. Okay.

Q. Is that what that says?

A. I could sure read it.

Q. I can —

A. Yes.

Q. He split from Kelly with two hot shot managers, correct?

A. Correct.

Q. And the article identifies or states that Mr. Kelly might pursue an acquisition other than a Beatrice unit and identifies, as previously reported one potential target is rumored to be Pillsbury Company, which recently underwent management changes, et cetera, et cetera, correct?

A. Correct.

Q. So at least as of August 22nd, we've got Grand Met identified as a potential, ah, raider of Pillsbury by Investment Dealers Digest, correct?

A. Correct.

Q. Is it fair to say that Investment Dealers Digest is

an industry magazine or a digest that's read?

A. That's the first time I've ever seen it.

Q. Okay. August 22nd ident — or strike that — 24th, we've identified Donald Kelly as a potential Raider of Pillsbury, correct?

[153]

A. Correct.

Q. And on the 2nd we've got Donald Trump, correct?

A. Correct.

Q. And the fact of the matter is, there are numerous others that may or may not be, including Kraft?

A. Correct.

Q. Now, Government's Exhibit —

MR. HAWKINS: I guess we talked about it as being Defendant's Exhibit 6; is that correct, Chris?

BY MR. HAWKINS:

Q. Defendant's Exhibit 6 is the newspaper article that Mr. Bebel referred to that you were quoted in?

A. Right.

Q. And that's from October 3rd, 1988, the date —

A. Correct.

Q. — before the announcement of the tender offer, correct?

A. Correct.

Q. And he talked to you about your position on takeover and whether Pillsbury had positioned themself, correct?

A. Correct.

Q. The very last paragraph talks about a Linda Singer. Do you know who Linda is?

A. No.

Q. They quote, said Linda Singer, a manager of options trading at Piper Jaffray. I'm even getting calls from [154] people at Pillsbury. Everybody thinks the company's being taken over.

That's the quote they attribute to her on October 3rd, the day before the tender offer. If you can read that.

A. It's what it says.

Q. Okay.

[156] * * * * *

Q. Okay. Now, you're familiar with an individual by the name of Dan Dorfman, correct?

A. I read him, yes.

Q. He's the Money Line columnist?

A. For U.S.A. Today.

Q. And he also has a cable news network or appears on strictly business on the cable CNN?

A. I never saw that.

Q. You don't watch that?

A. No.

Q. But you read his column?

A. Yes.

[157]

Q. Now, are you aware, and I'm showing you

Government's Exhibit 57. This is a transcript of Money Line from August 18th, 1988?

MR. BEBEL: Your Honor, I object. Are we to understand that this exhibit is in evidence?

MR. HAWKINS: I thought so.

THE COURT: Normally I make these decisions, but you guys have sort of worked this out. Do you want to get your heads together for a minute?

MR. HAWKINS: I thought this was your Exhibit 57.

(Discussion off the record.)

MR. BEBEL: We stipulated to the admissibility of this document, Your Honor.

THE COURT: In that case there's nothing for me to do again.

BY MR. HAWKINS:

Q. This is a transcript of Money Line from August 18, 1988, which is from CNN, Cable News Network, New York, New York, correct?

A. That's what it says.

Q. And Dan Dorfman, the bottom of the second to the last page of the transcript, and top of the last page says: Let's go on to Pillsbury up one-half. The story there is some people close to Grand Metropolitan apparently are telling people in the street that Grand Metropolitan is interested in acquiring Pillsbury. Pillsbury was up one-[158] half today, correct?

A. That's what it says.

Q. Okay. Now, people close to Grand Metropolitan generally relates to insiders, correct?

A. I would say so, yes.

Q. And in that regard, when you take information like that that you attribute to an insider, basically you attribute that as being a potential announcement, correct? I mean, that's —

A. I wouldn't say so, no, I wouldn't.

Q. I didn't say you would, sir. I said it can be viewed — maybe I did say you. It can be viewed as a potential announcement by people that are inside the company, correct?

A. I have no idea. That's not my opinion.

Q. But it is your opinion that people close to Grand Met would relate to insiders?

A. It could, sure.

[167] * * * * *

REDIRECT EXAMINATION

BY MR. BEBEL:

Q. Now, when companies that truly want to go forward — strike that. When you have a company that really, truly wants to go forward with a takeover bid, are those companies likely to leak out their intentions?

A. No.

Q. Why not?

A. Ah, it's illegal, number one. Number two, you would be [168] signalling, if there was another company out there that might be interested, your intentions and perhaps what you're willing to pay, and so it could actually up the price that you might have to pay or if you got into a bidding war. So you'd like to do it as quick and

fast as you can.

Q. So leaks can actually cost the bidder money?

A. Absolutely.

Q. Because it could cause the stock price of the target company to start moving up?

A. Correct.

Q. And then if the bidder wants to keep their premium in a constant level, it can cause them in the end run analysis to pay more money for that same company?

A. That's correct.

Q. And if it appeared that they might have to offer too high of a price, it could just kill the deal.

A. Theoretically, yeah.

[170] * * * * *

Q. And after you issued that sell recommendation, there were takeover rumors that were circulated. One of 'em is here in Exhibit 65a. It relates to Donald Trump's acquisition of Pillsbury stock, right?

[171]

A. That's right.

Q. And those rumors which came out after July 25th did not cause you to change your recommendation?

A. No, they didn't.

Q. Why not?

A. Well, at that point, the — I guess there's a couple things. I had my, the range that I felt the company could go for, and I think I moved it up because there had been some transactions, so we're talkin' mid forties. The

stock wasn't that attractive in the takeover from there. And again, you know, people like Donald Trump, they're players and manipulators, but I don't consider them a serious people.

Q. And so you didn't take that Trump article seriously?

A. Ah, I didn't take it seriously, no.

Q. And to what extent were these takeover rumors which came out after July 25th a new phenomenon?

A. They were no different than what we'd been dealing with for the last year, year and a half.

Q. That during that time there had been a constant stream of articles about Pillsbury being taken over?

A. Pillsbury and many other food stocks. It's just what we were living with in that period of time.

* * * * *

[176] [TESTIMONY OF WILLIAM BROWNLIE]

[MR. BEBEL:]

Q. Okay. We're ready to start moving out of the background.

Take us back to 1988. Were Pillsbury options traded on the AMEX?

A. Yes, they were.

Q. To your knowledge was that the only exchange where Pillsbury options were traded?

A. Yes, sir.

Q. And focus on October 4th, 1988, what happened with respect to Pillsbury? Was a tender offer for Pillsbury stock announced that day?

A. Umm. Before the opening, before the opening of trading, ah, Grand Metropolitan announced a tender offer for all of Pillsbury stock at $60 a share.

Q. And what happened to the price of options for Pillsbury stock?

A. They shot up in proportion to the difference in prices.

Q. And then did you begin conducting an investigation into trading in Pillsbury options?

A. Yes, we did.

[177]

Q. And you focused on what time period?

A. Ah, from mid September, I think, starting with September 15th to October 3rd.

Q. And why is it that you were conducting this inves-

tigation?

A. Well, there was, ah, a large increase in activity prior to the announcement, and there was, ah, is quite a large jump in value of the options.

THE COURT: And what were — excuse me. What were the dates that you said you were inquiring into?

THE WITNESS: September 15th to October 3rd was the original time frame of our investigation.

THE COURT: Thank you.

BY MR. BEBEL:

Q. And then did you ever look at trading that fell outside of that time frame also?

A. Well — yeah — yes. That's — we, we have — we have certain information at our fingertips that will give us large positions. And from that we go back and see where those large directions came from. They might have been outside our time frame, then we also ask for information involved in those trades.

Q. So then if you saw that someone held a large position, you might also see that they were buying before September 15th?

A. Correct.

[178]

Q. And when you were looking at large positions, did you come across the name James O'Hagan?

A. Yes, we did.

Q. And what did you notice with respect to James O'Hagan's options position?

A. Well, we noticed, umm, that his position was the

largest position that was held by an account.

Q. So that meant what?

A. Well, he was the largest trader in Pillsbury options at that time.

Q. And what do you mean the largest trader? You mean he had bought the most Pillsbury options?

A. Yes, he had bought the most Pillsbury call options.

Q. More options than anybody else?

A. Anyone else in the world.

Q. And why do you say the world?

A. Because the options only trade on the Exchange, and we reviewed the activity, and his was the largest position.

Q. Do you recall approximately how large his position was?

A. 2,400 contracts.

Q. 2,400?

A. 2,400, yes.

Q. And that gave him the right to buy how many shares of Pillsbury stock?

[179]

A. Well, each contract is equivalent of a hundred shares, so it would be 240,000 shares.

Q. And you worked in the options surveillance department for approximately four and a half years?

A. Correct.

Q. How usual or unusual was it to come across an

individual buying 2,400 options?

A. Highly —

Q. Option contracts?

A. I would say highly unusual.

Q. How many times during your four and a half years did you see a situation where an individual had bought more option contracts than the defendant had bought?

MR. HAWKINS: Your Honor — excuse me, sir. I'd object as being irrelevant, Your Honor.

THE COURT: You may answer.

THE WITNESS: I'd say that was the largest position I'd ever seen by an individual.

[181] * * * * *

[Mr. Hawkins:]

Q. The government asked whether or not you looked into trading by Mr. O'Hagan. Do you remember in looking into trading by an individual by the name of James Long?

A. Yes, that name is familiar.

Q. Who was Jim Long's broker?

A. If I remember correctly, it was also — it was Steuart Evans.

Q. From Huntsville, Alabama?

A. I think so.

Q. What was the profit that James Long made in trading options?

A. I don't remember.

Q. Do you recognize what I've marked for identification purposes Defendant's Exhibit 17?

A. I believe so, yes.

Q. Okay. Do you recognize what I've marked for identification purposes as Defendant's Exhibit 5?

A. Yes.

Q. What's that?

A. That's my closing memo of investigation.

Q. Does that refresh your recollection as to what James Long secured in Pillsbury options as far as profit goes?

[182]

A. I'd have to say that if that's what I wrote that's what the number was.

Q. Do you recognize that as your report?

A. Yes, I do.

Q. What did you write?

A. Ahm, it says here $2,112,000 — $2,112,131.32.

Q. Now, did Steuart Evans, the broker himself, have any position?

A. Yeah, yes, he did.

Q. What did Steuart Evans the broker himself have in positions in Pillsbury options?

A. By memory, I couldn't tell you.

Q. Why don't you look at this and see if you can refresh your recollection. Here.

THE COURT: Gentlemen, you may be chatting, but

we can't hear you.

THE WITNESS: Sorry. It reads here 200 contracts.

BY MR. HAWKINS:

Q. Okay. And what was his profit in regard to the Pillsbury options?

A. $346,000 — $346,449.

Q. And his overall profit in regard to Pillsbury options and stock?

A. $456,096.

[184] * * * * *

Q. Tucker Fredrickson, according to your — Ivan Fredrickson — had individual positions we talked about in both options and stock, correct?

A. He had options, I don't remember if he had stock.

Q. Okay, I apologize. Options. Right?

A. Yes.

Q. But he also had another position as a result of his partnership in CF Partners, correct?

A. Yes.

Q. You also learned that CF Partners had purchased options through Goldman Sacks?

A. Goldman Sacks.

Q. New York based?

A. Yes.

Q. What kind of money did Tucker Fredrickson and CF Partners make through Goldman Sacks?

A. I don't remember.

Q. Do you have that in your report there?

A. It's probably in here somewhere.

Q. That help you?

A. Correct. Okay. Here we go. Let's see, they purchased, according to this, looks like 570 options.

Q. What was their profit?

[189]

A. Ah, it says here $1,038,027.

Q. Now, there was another client of Steuart Evans who traded in Pillsbury options by the name of Morris Frank?

A. Yes.

Q. And he's from Huntsville, Alabama, the hometown or the town that Steuart Evans is from?

A. Umm, it says so here.

Q. What monies did Stuart Frank —

THE COURT: Morris?

BY MR. HAWKINS:

Q. Morris Frank make in Pillsbury options?

A. $290,477.

Q. 290 or is it 2,900,000?

A. It says 290,000.

[193] * * * * *

Q. A review of Evans' order tickets revealed that the majority were marked solicited but a few were marked

unsolicited. Correct?

A. That's what it says.

Q. According to your investigation, Steuart Evans was advising people to buy options contracts in Pillsbury, correct?

A. I would say more of the SEC's investigation.

Q. I'm — okay.

A. Because a lot of this information we gathered we handed over to the SEC then they carried the ball, I guess you'd [194] say. We mostly what happens in a case like this is we do preliminary investigation, we gather preliminary investigation, turn it over to the SEC, and then they go further with it. They were the ones who did the, umm, depo — excuse me — deposition.

Q. Your participation here, your review of the order tickets disclosed to you that Steuart Evans had been advising customers to invest in Pillsbury options, correct?

A. If that's what it says in the memo, I don't —

Q. Did I read that wrong?

A. Yes — no.

Q. Okay.

MR. HAWKINS: May I have a moment, Your Honor?

THE COURT: Certainly.

(Discussion off the record.)

BY MR. HAWKINS:

Q. Do you recall what the total option positions that Steuart Evans' customers held?

A. Total of 'em combined? No, I don't know the figure.

Q. Showing you specifically what's been marked for identification as Defendant's Exhibit 18. Do you recognize that as part of your report?

A. Yes, I do.

Q. Does that show you what his total positions of — customers' total positions were?

[195]

A. Yes, it does.

Q. How many total options did his customers purchase?

A. 4,335 contracts.

Q. How does that relate to number of common shares of Pillsbury stock?

A. Ah, 433,500.

Q. And how much did the total amount of the profits of his customers come to?

A. Ah, it says here $7,480,000.

Q. And what's the grand total profit relate to?

A. Ah, the grand total of probably stock and options combined it says 8 million — $8,017,000.

Q. How many total customers does that relate to of Steuart Evans?

A. I think it was five.

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

FOURTH DIVISION

Criminal No. 4-92-219

UNITED STATES OF AMERICA, *PLAINTIFF,*

v.

JAMES HERMAN O'HAGAN, *DEFENDANT.*

Volume IV
January 24, 1994

TRANSCRIPT OF PROCEEDINGS

HAD BEFORE THE HONORABLE
JAMES M. ROSENBAUM, and a Jury
Minneapolis, Minnesota

APPEARANCES:

For the Government	Christopher Bebel Jon Hopeman
For the Defendant	Charles Hawkins
Reported By:	Dawn M. Sampson, RPR-CM

* * * * *

[TESTIMONY OF CHARLES ALAN PARKER]

[3]

[MR. BEBEL:]

Q. During 1988, was Cravath retained by a company named [4] Grand Metropolitan?

A. Yes, we were.

Q. And approximately when did that occur?

A. It occurred on July the 11th and July the 12th of 1988.

Q. And when did you become aware of this?

A. I first became aware that we were going to be engaged on the afternoon of July the 11th.

Q. And it was your understanding that the firm was to be engaged to do what?

A. When I first learned of the engagement, I was told by the presiding partner of our firm that we were going to represent Grand Metropolitan in connection with what would probably be a hostile acquisition of the Pillsbury Company.

Q. Effected through what means?

A. The expectation was that it would be, umm, effected through a hostile tender offer.

[6] * * * * *

Q. All right, let's move on. At the time that you got on board, had any financial advisors been retained?

A. Yes. A few weeks before we were retained, Grand Metropolitan had retained two financial advisors.

Q. Tell us what the names of these financial advisors

are, what role they played.

A. There were two. As I mentioned, the first was S. G. Warburg and [7] Company, Limited, (phonetic) in London, as well as its New York based affiliate, which is S. G. Warburg and Company, Incorporated. They were involved in all aspects of planning for the offer, but they were primarily focused on the United Kingdom aspects. Grand Metropolitan also retained Morgan Stanley and Company, Incorporated, a New York based investment bank, and its London affiliate, Morgan Stanley International. They again were involved in all aspects, but their primary focus was on the United States aspects of the tender offer and the related financing.

[8] * * * * *

Q. And you knew the expected target was Pillsbury, right?

A. Yes, we did.

Q. And you knew Pillsbury was located in Minneapolis, Minnesota?

A. Yes, we did.

Q. So did you go about retaining a Minneapolis law firm to help out on the deal?

A. Yes, we did.

Q. What firm was that?

A. We retained Dorsey & Whitney here in Minneapolis.

Q. And their role was to be what and how did that role further the deal?

A. Their, umm, their role really was expected to have three aspects. The first was that we needed advice from

local counsel in connection with compliance with the Minnesota Takeover Disclosure statute. We also needed a firm here in Minneapolis that would provide us with help in connection with Minnesota based litigation that we thought was likely to occur. And finally, and in some ways most important, we were hopeful that Dorsey & Whitney would be able to provide us with a substantial amount of help in the public relations arena. Because of their ability to schedule appointments with various public officials here in Minnesota.

[9]

Q. And Dorsey & Whitney was retained approximately how long after your firm got on board?

A. Their official retention was approximately a week after we were retained. I believe it was on the 19th of July.

Q. After the Dorsey & Whitney firm was contacted, did you become involved in any discussions with Dorsey & Whitney attorneys relating to this upcoming deal?

A. Yes. I did. My — one of the primary discussions was actually before they were retained. I was involved in two extensive telephone conversations in which I conveyed to them the background of the offer and what we expected to do, and then I spoke with them on, if not on a daily basis, several times a week after they were retained in connection with the offer.

Q. Now, you referred to two telephone conversations. What Dorsey & Whitney attorneys were involved in these telephone conversations?

A. The, ah, initial conversation I was involved in was, umm, one with Peter Dorsey, who, umm, was at least then a senior member of the Dorsey Whitney firm.

Later that day I had a conversation with Tom Tinkham, who was another member of the firm, Dorsey & Whitney.

Q. And Dorsey and Tinkham were both told about what your intentions were, i.e., the tender offer for Pillsbury?

A. Yes, they were.

[10]

MR. HAWKINS: Your Honor, with all due respect, I object to counsel's continuing leading questions.

THE COURT: Sustained.

BY MR. BEBEL:

Q. Well, what information was conveyed to Peter Dorsey during this telephone conversation?

A. We told him, umm, who the target was, Pillsbury. We also told him who our client was, Grand Metropolitan. In order to insure that they didn't have any conflicts of interest that would preclude them from representing Grand Met. We also told him the expectation that it would be a hostile offer. And, umm, what the expected timing was in terms of when the offer would be launched.

Q. Okay, how about Tinkham?

A. My conversation with Tinkham was more of a nuts and bolts conversation where I conveyed to him my belief that the offer would be vigorously resisted by Pillsbury and would involve an extremely contentious legal and public relations battle, and I also talked to him about the litigation that we expected to have happen during the offer.

Q. Now, the Grand Met parent company is named what?

A. Its official name is Grand Metropolitan Public Limited Company, or PLC.

Q. Based where?

A. They are based in London.

[11]

Q. And the board of directors sits where?

A. The board of directors regularly sits in London.

Q. Now, did you draft any resolutions for the board of directors.

A. Yes, I did.

[15] * * * * *

Q. Now, when you first began working on this upcoming tender offer, were you advised of what the expected launch date was?

A. Yes, I was.

Q. And by launch date I mean the date on which the offering would be made?

A. Yes, I was.

Q. And what was the launch date that was originally intended?

A. It was to be either immediately before or immediately after Labor Day, 1988.

Q. And was that moved back?

[16]

A. Yes, it was.

Q. To when?

A. Umm, it was moved back to, umm, the middle part of September. The precise date that it was set on was I believe September 21.

Q. Did it go forward on September 21?

A. No, it did not.

Q. So what happened?

A. Umm, on the weekend before September 21, there had been a great deal of work done in connection with making the final preparations to launch the offer, and there was a decision at that point by Grand Metropolitan that they wanted to delay the offer for a couple of weeks because they were in the very final stages of negotiating the sale of one of their divisions, Intercontinental Hotels, and they were concerned that —

MR. HAWKINS: Your Honor, I'd object to the witness testifying regarding hearsay. I'd object to the witness testifying about hearsay about what Grand Met was concerned about.

THE COURT: Sustained.

BY MR. BEBEL:

Q. So the launch date, though, was pushed back from September 21st, in any event?

A. Yes, it was.

[17]

Q. To what date?

A. Umm, initially it was decided it would be sometime in the two weeks that followed September 21st, and then a few days later it was formally established as

October 4.

Q. And on October 4th, was any document filed with the SEC, Securities and Exchange Commission?

A. Yes.

[19] * * * * *

Q. Well, do you recall what happened to the price of Pillsbury stock after this document was filed?

A. Yes. On October the 4th, after the offer was announced and this document was filed, the price of the stock rose dramatically from the, ah, the trading price of the day — on the day before, the close of the day before, business day before, to, ah, slight — slightly below $60 per share.

Q. And do you recall where this trading range was the day before?

A. I —

Q. Is there any reference in the tender offer prospective or offer to purchase documents?

A. Yes, there is an offer to purchase, a table that lists the trading price. Umm, from this I do remember that the — the price was in the thirties during the period prior to the offer. And then on the day before the offer, the close was 39 and 1/8.

Q. And once the price shot up, how — well, let me rephrase that. How quickly did the price move up?

A. My recollection was that trading was suspended that morning, that trading was halted, and so the opening bid [20] price was at that — that number right below $60 per share. So it rose from 39 up to almost 60.

Q. And was that rise in line with expectations?

A. Yes, it was.

Q. Now, as for the exhibit that you're referring to, Government's Exhibit 52, when did you start drafting that document?

A. I began drafting that document late in July or very early August.

Q. And how many revisions did you go through?

A. Probably the best word to use is countless. It was revised a number of times.

Q. Well, were any steps taken to keep that document confidential while you were working on these drafts and revisions?

A. Ah, yes, there were steps taken. The, umm, the document was on a word processing disk, and, umm, the only person who had access to that disk was my secretary.

I kept the disks locked in my desk at night, and, ah, we also did not include the names of either Pillsbury or the Grand Metropolitan in those disks or in the hard copy of the document until very late in the tender offer process. We also tried, to the fullest extent we could, to keep the document on our premises so that it could not get out to, ah, any third parties.

[21] * * * * *

A. Well, the focus was to try to keep the document in [22] as few hands as we possibly could. We didn't want to send the document out by any means to anybody working on the team in the hope that it would remain as confidential as it possibly could.

Q. And were any other steps taken to preserve the confidentiality of that document?

A. Well, there were a number of steps taken in connection with the confidentiality of this document and confidentiality generally. One of the primary steps was the formation of a working group. Basically consisting of people who had an absolute need to know about the transaction and to read this document. We also did our best at all times to use only documents that had code names in it or no names at all, in order to keep anyone from knowing who the target was. And to the fullest extent we could, we tried to limit absolutely the production of documents generally so there wouldn't be a lot of writing relating to the possible offer.

Q. Well, why were you trying to keep this matter confidential?

A. Well, there were really two primary reasons. One was a legal reason, the other was a business reason. We first believed that we had a legal obligation to insure that the information did not fall into the hands of people who would appropriate it for improper use. That's the legal reason.

[23]

The business reason is that the making of a hostile offer at a substantial premium over the existing market price has a substantial psychological effect on both the company and the shareholders, and we wanted to insure that information did not get out, there by leading to a run-up in stock price, reducing that psychological advantage.

Q. Well, how would this information bring about a run-up in the stock price of Pillsbury?

A. Well, to the extent that information relating to the possible offer became public, ah, people would begin to trade on it, and it would cause the price to rise, because

it would be more demand for the shares.

Q. And if the price rose, ultimately what could happen?

MR. HAWKINS: Your Honor, I object as calling for speculation.

THE COURT: You may answer.

THE WITNESS: If the price rose, it would almost certainly reduce the psychological advantage involved in offering a significant premium over the offer price. It might itself also lead to a, the possibility that in order to gain the company the bidder might pay more, have to pay more when all is said and done.

BY MR. BEBEL:

Q. Well, why do you say that?

A. In the context of these hostile offers, it is sometimes [24] the case that bidding contests, umm, will ensue, or you will have a company interposing its, umm, I'm sorry this runs into some rather technical terms, but interposing its shareholder rights plan or poison pill in an effort to deter or delay the offering.

And if you've lost that psychological advantage, it was our view that you might end up in a situation where in order to end the offer quickly you might just raise your price and end up paying more than you originally would have if you could have made it a traumatic [*sic*] first strike with a traumatic [*sic*] premium over the existing offer price.

Q. Could you go through that again using a little bit more simple language?

THE COURT: If a stock is at $20, an offer to buy at 60 is more exciting than if the stock were at 50.

THE WITNESS: Yes, Your Honor.

THE COURT: I think we've now killed the horse.

MR. BEBEL: Okay. Well, we'll move on then.

BY MR. BEBEL:

Q. While you were — well, let me back up. Are you familiar with Dan Dorfman?

A. I'm familiar with who — who he is.

Q. Well, who is he?

A. He is a, umm, a syndicated columnist and I believe sometime television commentator on financial matters.

[25]

Q. And while you were working on the deal, did you ever become aware that Dan Dorfman had made comments about the possibility of Grand Met making a bid for Pillsbury?

A. Yes, I did.

Q. And when did you become aware of Dorfman's comments in relation to when those comments were made?

A. Umm, I learned the next day, through a summary of press reports relating to Pillsbury that were circulated by the public relations firm that was involved in the offer.

Q. What general time frame were these comments made?

A. My recollection was that the comments were made in the — in the range of late August of 1988. Could have been early September, but I believe late August.

Q. Now, after you became aware of those comments, did you — did you discuss those comments, Dorfman's comments, with anyone?

A. Yes, I did.

Q. And who did you have this discussion with?

A. Well, I had the discussion with, umm, Kirsten Feldman, who was a vice president of Morgan Stanley, and Paul Walsh, who was the chief financial officer of Grand Met's offices in the United States.

Q. And this conversation would have occurred when?

A. Okay. My recollection is that it occurred the early afternoon of that next day, after the Dorfman comments.

[26]

Q. And Kirsten Feldman, her area of expertise was what?

A. She was a vice president focusing on mergers and acquisitions at Morgan Stanley.

Q. Now, as a result of this conversation, it was decided to do what?

A. We decided to do nothing.

Q. Why did you decide to do nothing?

A. We advised Grand Metropolitan that they had no duty, ah, no obligation at all to respond to the market rumor like that. And, umm —

Q. Well, why do you characterize it as a rumor?

A. I characterize it as a rumor because, umm, in part it was — it was almost couched as a rumor. It was — it was — if I remember correctly, part of a general discus-

sion by Mr. Dorfman of sort of general financial gossip at the time. And, umm, he characterized it as something that he had heard. It was never characterized as any sort of official announcement by anyone either at Pillsbury or Grand Metropolitan.

Q. So why else did you decide to do nothing?

A. Well, at that time it was really — there was really nothing to do. It had not changed the dynamics of the offer process at all. It was — it was really considered by our working group to be a nonevent.

Q. And just briefly, why was it considered to be a [27] nonevent?

A. Well, at that point we were focused on things that would affect the timing of the offer, or the price that would be paid. And when we stood back and looked at all the events surrounding the announcement, with the timing, the substance of what was said, and what appeared to us to be a lack of market reaction to the — to the, ah, Dorfman comment, it didn't seem that any response would be necessary, even if Grand Metropolitan had any obligation to respond, which they did not.

Q. And what do you mean by lack of market response?

A. Ah, I had — I had myself looked at the trading that had occurred in the stock, and also consulted with Kirsten Feldman, and there had been a discussion to the effect that there had been no reaction or virtually no reaction in the common stock market with respect to the remark Dorfman had made.

[30] * * * * *

Q. Well, were there any expectations as to what

would and would not be done with this information at Dorsey & [31] Whitney.

MR. HAWKINS: Object as being irrelevant, Your Honor.

THE COURT: You may answer.

THE WITNESS: Well, it was certainly my expectation that the information would be held in strictest confidence. Umm, and then —

BY MR. BEBEL:

Q. By strictest confidence, you mean what?

A. I — I had had discussions with — specifically with Tom Tinkham about the, the processing of information within the firm, I discussed with him what our procedures were at Cravath in terms of the protection of confidential information. And, umm, he and I generally discussed the fact that the information was confidential and was to be limited to those people who had a strict need to know the information in connection with the work that Dorsey & Whitney would do for Grand Metropolitan in connection with the offer.

[61] * * * * *

[MR. HAWKINS:]

Q. And in fact, the first time that the price of $60 was ever thrown around was on September 15th, 1988, correct?

A. It was the first time that I heard any discussions on the part of the senior management of Grand Metropolitan as to what their price would be. There was certainly discussion within the working group earlier as to what the price might be.

Q. Well, there was a meeting held on September 15th, 1988, correct?

A. That's correct.

Q. And one or the purposes of this meeting was try to come to a determination of what might be reasonable in making the tender offer, correct?

A. The purpose of that meeting was for Morgan Stanley primarily, but also S. G. Warburg to come in and make an official presentation as to what they thought the price should be. It was the time they were going to give their recommendation.

[66] * * * * *

Q. Now, by September 15th, 1988, Dorsey & Whitney's law firm was no longer involved in any of this, correct?

A. That's correct.

Q. Now, do you recall the actual date that you were advised that Dorsey & Whitney would not be involved in this any longer?

A. Yes, I do.

Q. What day was that, sir?

A. September the 9th, 1988.

* * * * *

Q. Now, you were advised, and I'm not — maybe you can tell me by who, that Dorsey & Whitney had not realized there [67] would be hostile litigation in regard to Pillsbury, correct?

A. That — that was stated to me by Thomas Tinkham.

Q. Do you know when that occurred?

A. Yes, I do. It was on, ah — it was on Sunday the 11th of Sep —

Q. Do —

A. I'm sorry. Two days later.

Q. Two days after they'd already gotten out, you called or he called you?

A. Well, what had happened was, if I'm not mistaken, the call from Dorsey to Maulsby was really just to inform Maulsby that this — Dorsey was going to withdraw. Umm, at that time we were very concerned about the impact of that, and I — I called and tried to reach Thomas Tinkham before I got on an airplane back to New York. I was not able to reach him, but left word with his office that I would like to speak with him over the weekend, and I actually did get in touch with him on Sunday where we had a, a long conversation about the reasons why they wanted to withdraw.

Q. And one of the reasons was they did not realize it would involve hostile litigation, correct?

A. That was the — that was the phrase he used.

[70] * * * * *

Q. Now, when Dorsey & Whitney were initially contacted, they were contacted and asked by Cravath, Mr. Maulsby and yourself?

A. Yes.

Q. To research two issues, correct?

A. Are you referring to issues with respect to their possible engagement or substantive issues relating to the offer.

Q. Substantive issues. And let me see if this helps you. When Dorsey & Whitney were contacted, one of the things you wanted them to learn for you was the status of what's known as the Minnesota anti-takeover law, correct?

A. It's been a long time now. If I remember correctly, there were two Minnesota statutes. One was the old takeover disclosure statute which was a rather old statute. And the other was a more recent anti-, general anti-takeover statute, shareholder rights, protection statutes, and I believe we did ask them to look at the latter.

[95] * * * * *

BY MR. BEBEL:

Q. How — how confident were the — how confident were you that this tender offer was actually going to take place?

A. At any particular point in time?

Q. Well, say — let's talk about the end of August.

A. There was really no doubt in my mind at that point that barring some unforeseen problem, that we would make the tender offer. And by that I really mean some problem affecting Pillsbury itself.

Q. And you had had that position beginning when, approximately?

A. The first day that I met Ian Martin and Paul Walsh I knew that they intended to acquire Pillsbury. That was on July the 13th, 1988. Obviously people's plans can change, but they seemed very determined and, umm, frankly well equipped to engineer such a tender offer.

Q. And you were asked about the issue of security. What was the overall satisfaction from your perspective with respect to whether this tender offer information, tender [96] offer information was kept confidential?

A. I was very satisfied with the overall level of protection. I felt that people had understood what the precautions were to be and they had followed them very carefully throughout the entire process.

Q. And had you ever had any concerns as to whether this information about the upcoming tender offer had actually leaked out into the market as a whole?

A. Into the market as a whole? No, there were never any concerns that there had been any dissemination of the information or leaks of the information to the market as a whole.

Q. And why do you say that?

A. Well, I — it was certainly my view that if there had been such a leak the price would have reacted, umm, in a reasonably dramatic fashion.

Q. And you didn't see that?

A. I did not ever notice any trading volume or price movement. That would have been significant enough to signal such a dissemination.

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

FOURTH DIVISION

Criminal No. 4-92-219

UNITED STATES OF AMERICA, *PLAINTIFF,*

v.

JAMES HERMAN O'HAGAN, *DEFENDANT.*

Volume V
January 25, 1994

TRANSCRIPT OF PROCEEDINGS

HAD BEFORE THE HONORABLE
JAMES M. ROSENBAUM, and a Jury
Minneapolis, Minnesota

APPEARANCES:

For the Government	Christopher Bebel Jon Hopeman
For the Defendant	Charles Hawkins
Reported By:	Dawn M. Sampson, RPR-CM

* * * * *

[TESTIMONY OF JOHN SCHENK]

[MR. HAWKINS:]

[13]

Q. Now, Government's Exhibit 56, you've testified about the first page being the new file requisition, correct?

A. Correct.

Q. Who's the client?

A. The client is Cravath, Swain, and Moore.

Q. Is there any reference in there about a client by the [14] name of Grand Metropolitan?

A. No.

Q. If I were to call your records department, that's the name of the file, also, would it not be?

A. That's correct.

Q. So if I wanted to find out whether or not there was any file for a law — or for a company by the name of Grand Metropolitan or try to check to see if there was any representation of Grand Metropolitan, this wouldn't help, correct?

A. That particular document would not help.

Q. And this would be the name that would also be in the records center for the file, correct?

A. Correct.

[TESTIMONY OF ROBERT STRUYK]

[MR. BEBEL:]

[37]

Q. How did that business come into the firm?

A. Ah, it came into the firm through a partner of the firm, Peter Dorsey. Came in by referral from, ah, a law firm in New York. The name of Cravath, Swain and Moore.

Q. How long has Peter Dorsey been a partner in the firm, approximately?

A. He was a partner before, ah, I was a partner, so I suspect that it must have been 35 years ago.

[38] * * * * *

Q. Now, when Grand Met became a client in 1988, was it a new client?

A. Yes.

Q. And during that time period, was anything done to keep this matter confidential, the fact that you were working on behalf of Grand Met?

A. Ah, Yes.

Q. Well, what was done in that regard?

[39]

A. Ah, at the time that the client, ah, came in, and Mr. Dorsey spoke to me about it, we spoke about the necessity for keeping the matter confidential. Umm, we tried to limit the information to as few people as possible, on a kind of need-to-know basis within the firm. We, ah, opened the file, not under the name of Grand Met, but under the name of Cravath, Swain, and Moore, and

expedited the file opening, ah, in order to, ah, prevent wide publication, ah, of the opening of the file.

Q. Can you tell us what you mean by expedited? Can you explain that a little bit further?

A. Ah, the normal procedure was to open a file in the name of the client, and we — which would have been Grand Met in this case, but we chose to open it in the name of Cravath, and, ah, to, umm, ahm, provide on the various documents opening the file a minimum of information.

Q. Okay. And showing you Exhibit 56, take a minute to put your glasses on. Would you look at the first two documents within that exhibit and tell us if in any way those evidence your intent to keep this matter confidential?

A. Ah, yes, they do.

Q. Just briefly, walk through that.

A. Well, the new file requisition, which is Exhibit 56, ah, has the client name as Cravath, Swain, and Moore, and the fact that the billing is to be sent to Mr. Alan Parker at [40] Cravath, Swain, and Moore. It does not mention Grand Met. It refers to the subject matter of the representation as general, and there is a notation on this document which was signed by Mr. Tinkham and Mr. Dorsey, that this matter has been cleared with Robert Struyk.

Q. Second page also has a description of the matters to be worked on as general matters?

A. Yes. Second page is the client screening form, which would normally have details relating to the nature of the representation. But because of the confidentiality we omitted all of that information.

Q. Okay. All right. Let's shift gears a little bit. After Grand Met became a client, did any tension or disagreement develop within the firm as to whether or not the firm should be doing this work on behalf of Grand Met, and also I suppose you're going to have to tell us what kind of work you were expecting to do on behalf of Grand Met.

A. To answer the first question, yes. It developed almost — attention developed almost immediately. Umm, and the work that we were retained to do was in connection with a tender offer that Grand Met was considering making for the Pillsbury Company.

Q. Tell us a little bit about this tension that started to develop.

A. At the time that Mr. Dorsey told me that we had been [41] approached to represent Grand Met, I expressed concern to Mr. Dorsey about that representation. My concern stemmed from the fact that we had previously been asked to present, ah, businesses from outside Minnesota in terms of hostile takeovers of Minnesota companies, and a number of, ah, the lawyers, partners in our corporate department felt very strongly that we should not be in the position of taking on representation of, ah, of people, of companies attempting hostile takeovers of Minnesota companies, because it injured our relationship, which is very strong in the community, with the business community.

Q . So that was the view of the corporate department. What about the litigation department, though?

A. I think that the litigation department felt that we should take those matters on because it meant a lot of additional and very interesting work in terms of litigation area.

Q. Now, Mr. Struyk, after this tension started to surface, were these different viewpoints discussed at any meeting which you attended?

A. Yes. They were.

Q. When did that meeting take place?

A. Ah, that meeting took place on August 26th, the morning of August 26th of 1988.

Q. And was a decision reached at that meeting with respect [42] to whether or not the firm would go forward with the representation?

A. Ah, yes, we —

Q. What was decided?

A. It was decided that we would continue the representation.

Q. Was that decision later reversed?

A. Yes, it was.

Q. Approximately when did that happen?

A. It was reversed on September 9th.

Q. Now, while you were the managing partner and chairman of the policy committee, did the firm have in place any formal policy outlining the nature of the attorney-client relationship?

A. Ah, yes, it did.

Q. And by attorney-client relationship, I mean, attorneys within Dorsey & Whitney, vis-a-vis clients that your attorneys were representing?

A. Yes.

Q. And if you look at Exhibit 53, is that, ah, the policy

that was in place during 1988?

A. Ah, yes, this appears to be a copy of that policy.

Q. And who in the firm received a copy of this policy? Who was it distributed to?

A. This was a part of the lawyer's manual, and, ah, I believe also the office manual, certainly the lawyers' manual which was distributed to all associates and partners in the firm.

* * * * *

[MR. HAWKINS:]

[57]

Q. Now, after it's reviewed and the file gets opened, the file goes down to the records —

A. The file request goes down to the record center.

Q. And they open the file?

A. That's — they open the physical red folder file, yes.

Q. Put the name on it?

A. Yes

Q. And that's predicated upon the screening form, correct?

[58]

A. The screening form is one of the documents that is required before that's done, yes.

Q. Okay. So in looking at Government's Exhibit 56, this new file requisition and the attached client screening form go down and become part of the client file?

A. They go down to the record center. I'm not sure, I cannot recall whether they actually became a physical part of the file or whether they were retained in the record center.

Q. And then the record center generates a file, and identifies the client, based upon the client matter information that's contained on the new file requisition?

A. That's correct.

Q. So the file room is unaware of anything that happened between the lawyers involved in this, or who some hidden client or otherwise may be, correct?

THE COURT: Want to try that question again?

BY MR. HAWKINS:

Q. Yeah. They're only privy to the information that's sent down on this form, right?

A. Generally true.

Q. And specifically in this case, Mr. Tinkham talked to you about the need for extreme confidentiality, correct?

A. That's correct.

Q. And the file room wasn't told about any of these things, [59] correct?

A. Ah, I think I called the file room to tell them that, ah, they were to open the file with that minimal amount of information.

Q. Which was very scant in contrast to the normal screening and the normal information that they get?

A. That's correct.

Q. But you didn't advise them of anything in regard to Grand Met, correct?

A. Ah, no, sir.

Q. And so the file then was opened in the name of Cravath, Swain, and Moore with the billing to go to Cravath, Swain, and Moore, correct?

A. That's correct.

[61] * * * * *

Q. Back in 1988, the policy for a lawyer support staff, or any other individual associated with the firm for buying or selling a security of a public held company was [62] to check the file room to determine whether the publicly held company was a client of the firm, correct?

A. Ah, yes, I believe that's right.

Q. And in this case, with Government's Exhibit 56, and Defendant's Exhibit 19, if you were to call the file room and ask whether or not Dorsey & Whitney represented Grand Met, you would be advised, no, they did not, correct?

A. On the basis of this information, yes, I think that's what you would have been told.

Q. And that's what the obligation that you put on the lawyers at Dorsey & Whitney in determining whether or not they could trade in securities, correct?

A. That's correct.

Q. Now, if indeed the file room told the lawyer, yes, we're involved in litigation with Grand Met, then the lawyer is supposed to contact the billing lawyer of the client that's been identified, correct?

A. Yes, if the file room, not only with litigation, but if the file room had indicated we represent Grand Met, not only litigation.

Q. In anything, right?

A. That's correct.

Q. So on or about July 12th, 13th, 14th, 15th, all the way through September 9th when Dorsey & Whitney withdrew, anybody from a librarian to an associate in house development, or whatever part of the firm they were in, [63] called the file room and said, to check, do we represent Grand Met? Based upon your knowledge they would have been advised, we have no involvement with Grand Metropolitan?

A. That's correct.

Q. And based upon the procedures that you had at Dorsey & Whitney, they then would have been able to go and invest in Pillsbury stock, correct?

A. Yes.

Q. And in fact, on page 6 of Government's Exhibit 53, that's exactly what's provided for under implementation and demonstration of compliance, correct?

A. That's correct.

Q. And so we understand the scope of this, if I happened to have been officing next door to Tom Tinkham back in July of 1988, and I have some extra money laying around, and I wanted to invest in Pillsbury, under what you know about the way this file was, I would have checked to invest my money and I would have been free to do so under your firm's policies, correct?

A. I believe that's correct.

[TESTIMONY OF THOMAS TINKHAM]

BY MR. BEBEL:

[86]

Q. And you're a partner in the firm?

A. I am.

Q. And you've been a partner for approximately how many years?

A. Nineteen.

Q. And have you held any positions within the firm? If so, tell us about them.

A. Yes, I have. I have been on a number of committees in the firm, including the recruiting committee, the finance committee, the professional personnel committee, the partner [87] review committee, and, ah, I was chairman of the trial department, the litigation department at Dorsey and Whitney for three years, or three and a half years during the period '86 through '89, and I'm currently responsible at Dorsey and Whitney for the quality of practice, including issues about how we practice law, what we do in particular situations, claims made against the firm, ah, and work with various lawyers in those kinds of settings.

Q. Okay. Let's go to 1988. During 1988 did the law firm of Cravath, Swain, and Moore contact the Dorsey and Whitney law firm?

A. Yes.

Q. And when did you first learn that this contact had been made and tell us what the nature of the contact was, also.

A. I learned of it sometime in mid July of 1988 in a

conversation with, ah, Peter Dorsey and Bob Struyk, which they told me that the firm had been contacted by a man by the name of Alan Maulsby at Cravath, and asked if we were [88] interested in participating in some work that they were involved in.

Q. And then did the — did you later learn who this work — well, let me rephrase that. Was a file opened up after this contact was made?

A. Yes.

Q. And the name Cravath was put on the file?

A. Correct.

Q. And did you speak with any Cravath attorneys yourself?

A. Ah, yes.

Q. Okay. What Cravath attorney, or —

A. I believe his name was Alan Parker.

Q. And how soon after this contact had been made did you begin speaking with Alan Parker?

A. By late July of 1988.

Q. And by that time, had you been advised as to what the nature of the services were that you were being asked to provide?

A. Yes.

Q. And what was your understanding as to the nature of those services?

A. There was a company by the name of Grand Met, ah, that was, ah, primarily an English company that was interested in acquiring all of the stock of Pillsbury Company in Minneapolis. And in connection with that,

the people at [89] Grand Met would need to know a good deal about the law of the state of Minnesota as it applied to an acquisition like that. And they might also need some assistance in, umm, litigation or trial work in the event that there was litigation or trials of that kind in Minnesota involving a dispute that might develop over this proposed acquisition.

In addition, as it developed, they were also interested in, umm, whether or not Dorsey and Whitney could provide some services along the lines of introducing the people at Grand Met to various officials at the state and the county and so on.

Q. And this acquisition was to be brought about through what?

A. The acquisition was to be brought about, as I understood it, by the purchase of stock, a stock offering.

Q. A tender offer?

A. I think that's an apt — that's a word I'd use, yes.

Q. And as for these services that your law firm was to provide, who was to head up that representation?

A. Well, at least with regard to, ah, anything having to do with trial and litigation, I was.

Q. Now, after this business had been brought into the firm, did any tension or disagreement develop as to whether or not the firm should be doing this kind of work?

A. Yes. Yes, it did.

[90]

Q. Okay.

A. Although, let me just say that the tension was

there and preexisted this to some extent, with regard to this type of representation.

Q. And so then how soon does this tension start focusing on this representation after the business is brought in?

A. Well, within, ah, some relatively short time after I became aware of this possible representation, I also became aware that it was the desire of Bob Struyk to make sure that the corporate department was comfortable with this, and to meet with them and talk with them about that. And I then became aware that some of the people in the corporate department weren't comfortable with this.

Q. Were not?

A. Were not.

Q. And, on the other hand, people in the litigation department, what was their belief?

A. Well, generally people in the litigation department had discussed this kind of possibility before and thought that it was something that we could and should do.

Q. So you have two opposing viewpoints within the firm, generally speaking?

A. Yes, we did.

Q. And were those opposing viewpoints discussed at any meetings?

[91]

A. Yes, they were.

Q. Let's go to the first meeting. Do you recall when that was held?

A. Well, I recall when it was, because I've checked my calendar a good number of times with regard to it. It was on the 26th of August of 1988.

[93] * * * * *

Q. And generally, what was discussed and what was decided?

A. What was discussed was the pros and cons of representing someone who was going to acquire a substantial local company. The people, Rick Swanson, and Lee Mitou, took the position that it was inadvisable, it was wrong, inappropriate for us to do so because many of our clients [94] who were in similar situations, that is they were corporations in Minneapolis, who would be unhappy with our representing somebody who was kind of acting in a threatening way to another corporation, that was local.

I took the position, and I think Bob Struyk agreed with me, that in this situation, ah, this was ordinary, normal legal work that we were being asked to do. Umm, that, ah, as long as what we were being asked to do was substantial legal work, ah, of a kind regularly done, it should be something that we could do and our clients ought to perceive it as appropriate.

We recognized a tension and a disagreement existed. It wasn't resolved, except that we decided we would go forward with the representation but continue to monitor it to insure that in fact we were doing substantial legal work.

Q. Bottom line, you decided to stay with the case for the time being?

A. Correct.

Q. And prior to this August 26 meeting, were you

giving any thought to what your position would be at the meeting?

A. I — I was.

Q. And during the period before the meeting, did you receive James O'Hagan as a visitor at your office?

A. I did.

Q. And approximately when did this occur and what was [95] discussed?

A. I — I know that that meeting was before August 26.

Q. Why do you say that?

A. Because I discussed with him at the meeting what I was going to say and what position I was going to take at the meeting that was scheduled for the 26th. So I know the meeting preceded that day. Umm, my best memory is that it was a few days before then, but I can't be any more specific than that.

Q. Well, what causes you to think it was a few days before the August 26th meeting?

A. Because I had the meeting on my mind, enough so that I asked, umm, Mr. O'Hagan specifically about what position we ought to take when I went to that meeting.

Q. And his response, generally?

A. His view was, ah, the same as mine at the time, that, ah, this was the kind of work that, umm, Dorsey and Whitney ought to be able to do in the appropriate circumstance.

Q. And during this meeting, did the defendant, James O'Hagan, ever say anything with respect to Pillsbury?

A. Yes, he did.

Q. Well, maybe I better back up. Can you sort of walk us through the meeting and tell us how the conversation began?

A. Well, I remember, ah, being at my desk, and I remember, ahm, Jim O'Hagan coming to my — into my office and standing [96] inside the doorway. And talking with me as he was standing there. He began the conversation by saying that he understood that I was doing work on a takeover of the Pillsbury Company, and that, ahm, I would remember, as he put it, that he hated the Pillsbury Company —

Q. And what did you you understand that reference to refer to?

A. I had known for a good long time that Jim had a substantial case against the Pillsbury Company, or one of its subsidiaries, Green Giant, and that, umm, there had been a relatively high degree of animosity in the lawsuit. So that when he said that, that's what I thought, that he was referring to the case involving Green Giant.

Q. Okay. Keep walking us through it.

A. In any event, he, ah, he said, well, you know, I, I, umm, I don't like them, or I dislike them, and I would be interested in working on this case. Umm —

Q. And what was your reaction to that?

A. Well, my reaction was negative, and I said, umm —

Q. Why was your reaction negative?

A. My reaction was negative for two reasons, as I recall. First of all, umm, Jim O'Hagan and I had sub-

stantially different manners of approaching cases. And, umm —

Q. Explain that —

MR. HAWKINS: Well, Your Honor, that's irrelevant, [97] beyond that.

THE COURT: Sustained.

BY MR. BEBEL:

Q. Okay. So what was — what was your reaction?

A. What did I say?

Q. What did you say?

A. What I said to him was that I didn't believe that there was, umm, a lot of legal work developing on this. And, umm, it didn't seem like that would be something that would make any sense. Or words to that effect.

Q. And did you, ah, also alert him as to this tension?

A. Well, I remember saying to him that there was a question about whether we were going to continue this representation, and that I had to go to a meeting to discuss this with our corporate department that was taking its usual position that we shouldn't be doing this. And I asked him what he thought about it.

Q. And that's when he gave the response you previously discussed?

A. Correct.

Q. Now, who was more senior in the firm at the time?

A. He was.

Q. And does the fact that he was more senior in the firm have any bearing on your ability to remember this

conversation?

[98]

A. Yes.

Q. Explain that.

A. In a law firm, a large law firm like the one we were both in, typically the more senior lawyers are in charge of matters and the more junior lawyers work for them, and in fact, ahm, when I had started at Dorsey and Whitney and for six or seven years thereafter I worked on a number of matters, ah, for Jim O'Hagan when he was in charge of them. So that this was an unusual circumstance for me with somebody who was more senior in the trial department coming and asking me to work on a case where I was in charge.

Q. Okay. Let's move on a little bit. At the time he came into your office and began discussing this, did you — well, why was it that you were willing to discuss this matter with him? Did you think you were doing anything improper?

A. No. And as to the question why, umm, the first answer — the first part of the answer is because he asked, and the second is because he was a partner in the Dorsey and Whitney law firm.

Q. Well, what does that mean?

A. Umm —

Q. In what way did that, ah, allow you to think it was proper to discuss this with him?

A. Well, there may be some circumstances in which we try to keep information narrowly confined within the law firm about a client matter. The practical fact is, and the legal fact is, that all partners are charged with the

same knowledge, whether they really know it or not. So that, umm, any partner in the law firm has the right to know what is being done by the partnership. That's the essence of a partnership, as far as I'm concerned.

[106] * * * * *

[MR. HAWKINS:]

Q. And during this three to five minute conversation, during whatever time frame you had, you never talked to Mr. O' Hagan about Grand Met, correct?

A. You mean specifically mentioned Grand Met?

Q. Correct.

A. I don't remember.

Q. That's something you would have remembered, however, if it had happened, correct?

A. I don't know.

Q. It was important at the time, correct?

A. I don't think that who the acquirer was was particularly important in the conversation, no.

Q. That you guys were having?

A. I don't think it was important in our conversation.

Q. Because what the conversation was about was the general policy at Dorsey and Whitney about being involved in hostile takeovers, correct?

A. No. The conversation was about two things. The first of which was Mr. O'Hagan's desire to work on this specific matter, and the second was our general policy.

[107]

Q. So part of the conversation was about a general

policy relating to noninvolvement of hostile takeovers of local companies, fair?

A. That's correct.

Q. And the second part of the conversation was Mr. O'Hagan's willingness to work on this matter, correct?

A. Well, except you have them reversed. That was the first part of the conversation.

Q. I'm not trying to put them in any order, I'm just trying to identify the subjects.

A. Those are the two subjects.

* * * * *

[TESTIMONY OF DOUGLAS CARNIVAL]

BY MR. BEBEL:

[121]

Q. Okay. Let's move on then, the next point. And you, your firm, represented Grand Met in connection with what?

A. Ah, the bid to acquire the Pillsbury Company, sir.

Q. By means of a tender offer?

A. Yes, sir.

[122] * * * * *

Q. And prior to the time the bid was announced, did you limit the number of people involved in the matter in any way?

A. Yes, sir. We, ah, when we were retained, we, umm, convened a meeting of a very small group of people in the firm. The members of the management committee, if I remember, along with a few other people who would be actively working on the file, umm, and limited the, the, ah, information about the retention by Grand Met to that group.

Q. And why did you limit the flow of this information?

[123]

A. Ahm, because we were instructed to by the client, and by the Cravath firm, and because it was important to keep this information confidential, ah, because of its potential impact, if it were disclosed.

Q. And what potential impact did you believe there might be?

A. Ah, typically in a tender offer, the bid for the company is made at a price above the market price, and if that information, the fact that an actual bid was going to be made was disclosed, and someone knew with it, they'd be able to buy the stock at a price, at the market, and receive again, ah, at the time of the tender offer of the premium between the market and the tender price.

Q. So besides limiting the flow of information, what else did you do to keep this matter confidential?

A. Ah, we opened the file under a code name, umm, so as not to have any information in our office with either Grand Met's name on it or Pillsbury's name on it, and any documents or, ah, other materials that existed in the office used those code names.

Q. And how usual or unusual was it to use code names in connection with a case?

A. That's the first time we had had that experience, sir.

Q. Now, while you were working on this matter, did you have any [124] knowledge as to whether there had been any newspaper articles or magazine articles which talked about Pillsbury as a possible target of a takeover?

A. Ah, I can't tell you exactly the time frame, but I do recall on — I generally read the two local newspapers and the Wall Street Journal, generally on a regular basis, and I recall there being articles in, ah, one or all of those newspapers about Pillsbury as a potential target of a takeover along with obviously many other companies along the way.

Q. All right, then, if you had read these articles which talks — talked about Pillsbury as being a possible takeover target, why were you using code names and

limiting this information?

MR. HAWKINS: Your Honor, asked and answered.

THE COURT: Sustained. You may answer.

Overruled.

THE WITNESS: Ah, because we had actual information that a bid was going to be made, and that information is what — what's important to people. If you actually know a bid's going to be made, then you've, you've got the kind of information to, ah, to, ah, that other people don't have.

BY MR. BEBEL:

Q. And how did that differ from what was in these articles?

[125]

A. Those articles were all, I suspect, speculation, that something, that Pillsbury might be the target of someone's acquisition. The information that we had once we were retained was that, ah, this particular company was going to make a bid for this, ah, this company, Pillsbury, and that's very different from just general articles in the newspaper. It seems to me.

[TESTIMONY OF DANIEL STIBILE]

BY MR. BEBEL:

[134]

Q. After a customer makes a particular trade, are confirmation slips printed out?

A. Yes, they are.

Q. And what happens to these confirmation slips, and what information is reflected on these confirmation slips?

A. Confirmation slips are sent out to the clients, it's [135] stating what they did for whatever the trade may be. And the amount of money that's due.

Q. Well, let's look at Exhibit 38. Do you recognize the first document within the exhibit and the third document?

A. Yes.

Q. Are those confirmation slips?

A. Yes, they are.

Q. Okay. And also when orders are executed on the Exchange on the floor, where the security is traded, are order tickets filled out?

A. Yes, they are.

Q. Or — okay. And are order tickets also filled out by the broker after they receive an order?

A. Yes.

Q. Now, do you see any order tickets in this packet marked as Exhibit 38?

A. Yes, on the second page.

Q. And these order tickets, or this order got filled out by who?

A. It would be the broker.

Q. Okay. And all the documents within Exhibit 38, are they prepared and kept in the ordinary course of business?

A. Yes, they are.

Q. And let's look at the order ticket in Exhibit 38. That references the purchase of what security, and on what date?

[136]

A. 50 calls of Pillsbury options.

Q. On what date?

A. On — excuse me — 8/30 of '88.

Q. And whose account?

A. Mr. O'Hagan's account.

Q. James O'Hagan?

A. James O'Hagan.

Q. Okay. And the second confirmation slip references the purchase of what securities on what day, and in whose account?

A. 50 calls of Pillsbury options done on 9/8 of '88 in James O'Hagan's account.

Q. Now, if we could look at these account statements, prior to the period of August '88, does it reference the purchase of any options in the account of James O'Hagan?

A. Yes, it does.

Q. Okay. Tell us about that.

A. On the statement as of, for settlement of 6/5, there's five contracts being purchased on the MCA options.

Q. And aside from these five contracts in MCA options, does it reference any options being purchased in this account prior to August 1988?

A. No, it doesn't.

Q. And have you looked over that document prior to coming here today?

[137]

A. Yes, I did.

MR. BEBEL: Your Honor, I have a note from my learned colleague that I did not offer 37a or 38, so I now do so.

MR. HAWKINS: I have no objection, Your Honor.

THE COURT: 37a and 38 are admitted.

BY MR. BEBEL:

Q. Now, when an order for the purchase of options is received in a particular — let me back it up. By looking at any of these documents, can you tell where these Pillsbury options were traded?

Okay, you just pointed to something. Does anything that you pointed to let you know where these options were traded?

A. From where the, umm, report came back from, it has the letters A Z on it. Back when we traded them that would be the AMEX floor.

Q. American Stock Exchange?

A. Yes.

Q. Is that a national stock exchange?

A. Yes, it is.

Q. Located in New York, right?

A. Yup.

Q. And during 1988, when an order for to purchase some options was received in an office of Janney Montgomery Scott, how did the broker go about transmitting that order [138] to the American Stock Exchange?

A. He would give it to the order clerk, who would then enter it through our computer system, and then it would go, depending on how many contracts, it would go to the floor and then they would execute it from down there.

Q. So it's transmitted electronically?

A. Yes.

Q. And if you look at the monthly account statements, does it show whether the options that were purchased in the account of James O'Hagan were ever sold? And tell us, if so, when they were sold and how much money was received at the time of sale?

A. They were sold on 10/4 of — 10/4 of '88.

Q. And in case I didn't ask, those confirmation slips, how soon after the trade are they sent out?

A. As soon as the trade's done, the following morning they'd be sent out.

Q. And are they sent out through the U.S. Mail?

A. Yes, they are.

Q. And do they act as a receipt in any way?

A. Yes, they do.

Q. Well, explain that. Why do they act as a receipt?

A. Well, it confirms, it states the price of what is owed and counting — including commissions. And also on the back of the confirm, it states the, if you were sending a check [139] through the mail, to please send a receipt with it. The confirm splits into two parts.

MR. BEBEL: May I have a minute, Your Honor?

THE COURT: Yes, sir.

(Pause.)

BY MR. BEBEL:

Q. Now, on 10/4 when the options were sold, how much money was received?

A. One trade was for $76,195.94. That was 59 contracts. And 41 contracts for $53,310.70.

* * * * *

[TESTIMONY OF JUDY KALLAUS]

BY MR. BEBEL:

[159]

Q. And you see references to 5,000 shares of Pillsbury [160] being bought in the account of James O'Hagan, right?

A. That's correct.

Q. The customer name is listed here?

A. That's correct.

Q. And here, for the record, means top lefthand corner. And walk us through what — walk us through how to interpret the information listed on the line which says two, and then it gives a date of 8/3 and it says 5,000 Pillsbury?

A. Okay, the two indicates the type. The type determines whether it's a cash trade or a margin trade.

[161] * * * * *

This column indicates here that they bought, you either have a sale or a buy, this is the case that he bought 5,000 shares. Pillsbury Company is the name of the security purchased. This is the price per share that he purchased it at, which is 36 and an eighth, and this amount here is the net amount of the trade. The total number of dollars that the trade cost.

Q. Okay. So this would have been bought then on what day, July 27?

A. July 27th would be five business days prior, so that's the date that the order was actually entered.

Q. Okay. And let's just move down a little bit —

THE COURT: Now, the purchase price was how much, ma'am?

THE WITNESS: Purchase price is $36 — 36 and an eighth per share. That's the purchase price. The net amount of the trade was $182,108.54.

THE COURT: Now, what is 36 and an eighth mean?

THE WITNESS: That's 36 — that's representing dollars. So 36 and one-eighth dollar, or 36.125.

THE COURT: 36.12 and a half, right?

THE WITNESS: Right. Exactly.

THE COURT: Whew (whistles).

THE WITNESS: That indicates dollars.

BY MR. BEBEL:

Q. Do you see an entry relating to that sale of those same 5,000 shares not long afterwards?

A. Okay. This —

Q. Do you want to take the green —

A. Sure.

Q. — green marker? This would be the sale of those securities. Settlement date would be August 10th, which would be a trade date of the third? This column indicates that it's a sale instead of a purchase. Indicates that it's [163] Pillsbury stock again. The stock was sold at 38 and a quarter, which is 38.25. Per share. And the proceeds of the sale was 189,875.62.

Q. Okay. Now, we've gone through the purchase of Pillsbury stock. Do you see a reference down below that to the purchase of Pillsbury options?

A . Yes. This is the —

Q. Here's the — and here's the green marker once again. And you can just hold onto it, I'll get another marker.

Tell us how to interpret the information on the line you've just circled in green, which for the record says 2, then gives a date 8/19/'88 and references 20, call Pillsbury.

A. Okay, this indicates that 20 contracts were bought for settlement date of 8/19, which would mean trade date would have been 8/18, the prior business day.

[165] * * * * *

THE WITNESS: So this indicates on trade date August 18th for settlement of 8/19, he bought 20 contracts of Pillsbury calls, umm, September forties.

BY MR. BEBEL:

Q. What does September 40 mean?

A. September is the expiration month of the option, 40s —

Q. When does the September due day expire?

A. Third Friday of September.

Q. And it would have been September of what year?

A. 1988. Expiration is September 17th, 1988. So they're placed as September 40s because 40 is the striking price.

Q. Okay. You're going to have to tell us what that is.

A. Okay. The striking price is if the stock hits a certain price by the certain date whether the option could or could not be exercised. Whether they would buy the stock at that price.

Q. And if the price of Pillsbury would be selling below 40 at the end of the day on 9/17, what would happen?

[166]

A. The option would expire worthless. If it trades above 40, then there — then it could be exercised at the price of 40 .

[168] * * * * *

Q. Okay. Now, let's look at pages 4 through 7 of the statements for the same period, August 29th through [169] September 30th. Because it's 4 of 10 through 7 of 10. And why don't you just look along with me. 4 of 10, what's reflected on that page?

A. Ah, purchase of Pillsbury options. Seven of 'em. They're dated from August 31st through September 6th.

[179] * * * * *

Q. We were looking at these charts. You were just getting your pointer and your marker.

A. Now, we left off, and you were explaining that this is a blowup of one of the pages in 34 and 34a, and this blowup is page 3 of 10 of the period August 29th through September 30th?

A. Yes, it is.

Q. Okay. And generally, ah, what type of information is set forth on this account?

A. The top section lists out the securities and options, it's a summary of what is owned within the account at the end of the month.

Q. At the end —

A. On September 30th, 1988.

Q. Okay. And what does that show with respect to all of his holdings as of September 30th, all of his holdings of options?

A. Okay. This section here is the options section.

Q. Okay. Why don't you circle that.

A. Okay. Okay, this summarizes the options that are owned. They're all owned in Pillsbury Company. Long means they're options that you own. That's what long means. They're call options. This is the, ah, expiration month, the striking price, the actual expiration date, and this is [180] the number of contracts that's owned of each of the different options. And this is the market value of the options at the end of the month, not necessarily what was paid.

Q. Okay. So we don't have any — any September options here, right?

A. No.

Q. Why is that?

A. The September options would have, ah, been sold or expired. They no longer exist after their expiration date.

Q. And where — where — tell us what these October 40, October 45s are, the November 30.

A. Okay. As was shown in the purchase, it tells you what the expiration month is. That's the month that the option would expire. It's the third Friday of the month. That's the striking price, the price that the stock would have to be trading at to determine whether it's going to be —whether it's going to expire or it's going to be exercised. And this is the actual date that it expires. And

then that's the number of contracts.

Q. Okay. Now, and when you say this is the number of contracts, you mean there's two thousand Pillsbury October 40s?

A. Exactly.

Q. That had been bought by the defendant in his account?

[181]

A. That's right.

Q. And that's how many he held as of the end of the month?

A. That's correct.

Q. And he had bought 100 October 45s, and he held that in his account as of the end of the month?

A. That's correct.

Q. And he had bought 300 November 40s and held those in his accout as of the end of the month?

A. Yes, that is correct.

THE COURT: Now, ma'am, when it says number of contracts there, are those contracts each a contract for a hundred shares?

THE WITNESS: That's correct.

THE COURT: So the 2,000 —

THE WITNESS: 2,000, to tell you how many shares you're controlling, you add two zeroes, so that would be controlling —

THE COURT: 200,000.

THE WITNESS: 200,000 shares. Right.

[182] * * * * *

Q. And during your years in the securities business, have you ever seen any other situation where an individual has accumulated that many call options in his account?

[183]

A. No, I never recall seeing such a large position in options. I never have seen a position this large in options.

[184] * * * * *

Q. Now, after all these call options have been bought by the defendant in his account, what does he start doing in October?

A. In October we see several sales. A whole page of sales of those options.

[185]

Q. And what page are you looking at?

A. That's page 4 of 9 of the October 1 to October 30, '88, statement.

Q. And when are these sales taking place, what's the date of the sale?

A. The date of the sale would be October 4th, because the settlement date is October 5th, as date indicated on that statement.

Q. Okay. And do you see anything other than a reference to sale of Pillsbury options on October 4th on page 4 of 9?

A. No. Those are all sales of options. That's exactly what it is.

Q. Okay. And 5 of 9, what's reflected on that page?

A. Umm, all the entries for 10/5 and 10/6 are sales of options, the last four entries are a couple purchases of options, and a couple security purchases. Most — it's mostly sales of the options.

Q. All right. And those sales are taking place on October 4, and then you see a couple on October 5th also?

A. That's correct.

Q. That one, the ones that have the date of 10/6, those sales actually took place on 10/5?

A. Correct.

[188] * * * * *

Q. And when a customer purchases securities in his or her account, or sells securities in his or her account, are confirmation slips are printed up?

A. Yes, they are.

Q. And then they're sent out to the customer?

A. Yes, they are.

Q. By U.S. mail?

A. Correct.

Q. Okay. And those confirmation slips tell what the purchase or sale price was, and on what date the transaction took place and so on?

A. That's correct.

Q. Okay. And those are prepared in the ordinary course of business, right?

A. Yes, they are.

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

FOURTH DIVISION

Criminal No. 4–92–219

UNITED STATES OF AMERICA, *PLAINTIFF,*

v.

JAMES HERMAN O'HAGAN, *DEFENDANT.*

Volume VI
January 26, 1994

TRANSCRIPT OF TRIAL

HAD BEFORE THE HONORABLE
JAMES M. ROSENBAUM, and a Jury
Minneapolis, Minnesota

APPEARANCES:

For the Plaintiff:	Christopher Bebel, Esq. and Jonathan Hopeman, Esq.
For the Defendant	Charles Hawkins, Esq.
Reported By:	Dawn M. Sampson, RPR-CM

* * * * *

[TESTIMONY OF JUDY KALLAUS]

MR. HAWKINS:

[31]

Q. What was the percentage of his options in relation to his portfolio after he had purchased the Pillsbury options in 1988?

A. Just over ten percent.

Q. His position in options in 1988 in Pillsbury was basically the same as it was the year before in 1987?

A. On a percentage basis, yes.

[34] * * * * *

REDIRECT EXAMINATION

BY MR. BEBEL:

Q. On August 2nd, there is an article that appears in the Minneapolis paper talking about Trump's big time purchases in Pillsbury, right?

A. Correct.

Q. And on August 3rd, the defendant places an order to sell what?

A. Traded August 3rd, he sold 5,000 shares of Pillsbury.

Q. So he's selling the day afterwards?

A. Correct.

[46] * * * * *

Q. Now, this first purchase in Government Exhibit 35 relates to the purchase of Pillsbury forties on August 29th, right?

A. Correct.

Q. And showing you Government Exhibit 47, which is a printout of Pillsbury stock prices, on August 29th, Pillsbury stock was — it closed at what?

A. Thirty five and five eighths.

Q. So then those October forties were out of the money?

A. Correct.

Q. Because the striking price of forty was higher than the current market price of the stock?

A. Correct.

* * * * *

[TESTIMONY OF MICHAEL MULLIGAN]

[73]

MR. BEBEL:

Q. And let's get back to Government Exhibit 41, the [74] confirmation slip. That reflects a purchase by the defendant on what day?

A. Trade date was 9-20-88.

Q. And what type of securities were bought?

A. Bought was 5,000 shares of Pillsbury Company.

Q. And do you recall taking that order from the defendant?

A. Yes.

Q. Tell us what happened on September 20th when the defendant placed that order.

A. Mr. O'Hagan came into my office, and I asked him what he had been doing in the market, and he said his broker down south had bought some Pillsbury stock for him, and I said, well, why don't you buy some through me.

Q. And then what happened?

A. And he said all right. Go ahead and buy 5,000.

* * * * *

[75]

Q. Why did you direct her to mark it unsolicited?

A. Because I didn't feel that I had solicited an order to buy Pillsbury as an investment or trade idea. It was just basically asking for a piece of business.

Q. Explain that further.

A. In that Mr. O'Hagan spent a lot of time in my office, basically he would be in probably once a day, I felt that he should give me some commission business for the right of sitting at my area and punching my quotetron, drinking my coffee. I figured that I should be paid for that, and this is one way to do it. Give me some business, basically.

Q. And did you suggest in any way what company he should focus this business on that he was going to give you?

[76]

A. You mean which stock to buy?

Q. Yes.

A. At that moment, obviously, I meant Pillsbury, because he had just told me that they were buying some down south, and so I expected him, you know, when I said why don't you buy some from me, that it would be Pillsbury that he might give me an order in, yes.

Q. And, well, around this time period, what were your own thoughts with respect to the advisability of an investment in Pillsbury?

A. Well, there had been an awful lot of rumors, of course, about the takeovers and —

Q. What were you doing in your own account in connection with those rumors?

A. I had bought some stock earlier in the month and sold the stock out just prior, I think, to Mr. O'Hagan buying stock from me.

Q. When did you sell your stock?

A. I believe I sold it on the 19th.

Q. Of what month?

A. Of September.

Q. And he bought his 5,000 shares what day?

A. On the 20th.

Q. Well, why were you selling on September 19th, [77] given the fact that there were all these rumors in the market?

A. You know, at the time, there was so many, and at times, I, you know, where there is smoke, there's fire, so to speak. At times I thought, gee, there might be something to these rumors, so I would go from believing that, gee whiz, maybe Pillsbury is going to get taken over to thinking gee, what a — it's not a very well managed company, I can't imagine anybody wanting to buy it, and, so, in general, I think I bought and sold the stock twice. I thought there was enough, at least, rumors out there that, certainly, I could trade the stock just on the rumors that might take the stock up in value, so when I sold it on the — the 19th, I can't recall exactly why I sold it, but I would think that I didn't believe that it was going to get taken over.

[105] * * * * *

Q. And so what does that say with respect to rapid dissemination that this tender offer was just around the corner?

A. You know, it would appear that the information, if there was any information, wasn't affecting the price of the stock.

[TESTIMONY OF DAVID KUKURA]

[181]

MR. BEBEL:

Q. And give us a summary as for the option contracts which were purchased, how many were purchased through Shearson and how many through Janey, Montgomery, Scott?

A. The total purchases charged or the total purchases?

Q. Well, how about the total purchases that were charged?

A. Total purchases charged, there were 3,000 — or, I'm sorry. Total purchased charged, there were 2,5000 in total. 100 —

Q. How many purchases of options were there in total?

THE COURT: Let me back up. How are we using the word charged, as when I go into Dayton's?

MR. BEBEL: No. Reflected in the indictment.

So there's 2,500 option contracts reflected in the indictment?

THE WITNESS: That's right.

BY MR. BEBEL:

Q. And there were 3,000 contracts in total [182] purchased?

A. Correct.

Q. And of those 3,000, how many were purchased through Shearson, how many through Janey, Montgomery, Scott?

A. 2,900 through Shearson or Robinson, Humphrey, and 100 through Janey, Montgomery, Scott.

Q. And then, of the 2,900 that were purchased through Shearson, how many are not reflected in the indictment?

A. 500 are not charged in the indictment.

Q. And just so I'm clear, then, the total number reflected in the indictment is how many contracts?

A. The total charged is 2,500.

Q. So, then, but only 2,900 were purchased with Shearson?

A. There's 2,900 option contracts in total purchased through Robinson, Humphrey or Shearson.

Q. And so 400 of those are not charged?

A. 400 of that total are.

Q. Are?

A. 500 are not charged?

Q. Well, I'm too confused, so let's move on.

The purchases that are charged occur [183] after what date?

A. They occur after August 26th, 1988.

Q. And let's talk about the stock that's charged — There is 5,000 purchases of Pillsbury stock that are charged?

THE COURT: 5,000 purchases?

THE WITNESS: 5,000.

BY MR. BEBEL:

Q. 5,000 shares of Pillsbury stock?

A. Right. Charged with 5,000 shares of Pillsbury stock.

Q. And that was purchased though Dean Whitter?

A. That's right.

Q. And there is 5,000 shares of Pillsbury stock defendant purchased through Shearson that are not charged?

A. That's right.

Q. And those were purchased prior to August 26th?

A. Correct.

Q. And had you done any calculations with respect to profits earned on the securities trades that are charged in the indictment?

A. Yes, I have.

Q. And what have your calculations shown with respect to profits earned on the purchases [184] reflected in the indictment?

A. Mr. O'Hagan earned a profit on the options and stock that are charged in the indictment. A total profit of $4.3 million, approximately.

Q. Excluding commissions?

A. Excluding commissions, that's right.

[198] * * * * *

Q. And, by the way, just so we can take another stab at it, there were 3,000 option contracts purchased in total?

A. Right.

Q. And how many of those are charged in the indictment?

A. 2,500 purchases are charged.

Q. And how many of those 2,500 were purchased through Shearson?

A. 2,400.

Q. And the other 100 through Janey Montgomery?

A. Correct.

Q. We got it. We got it that time.

[200] * * * * *

Q. And how much did he sink into Pillsbury options in August and September 1988?

A. $258,762.

[202] * * * * *

Q. As for the Pillsbury options that expired worthless, those were Pillsbury September expiration date options?

A. That's right. They expired September 17th 1988.

Q. And during what time period was he buying those Pillsbury September options?

A. It was between August 8th and August 25th, 1988.

[203]

Q. And his last purchase of Pillsbury September options occurs August 25th?

A. That's right.

Q. And after that, what does he do with respect to the expiration date of his options?

A. He begins buying options which expire in October of 1988.

Q. And even after he loses that 27,825 that had been put in the Pillsbury options and that expired worthless September 17th, does he continue buying options?

A. Yes, he does.

Q. Pillsbury options?

A. Pillsbury options, that's right.

* * * * *

[206]

Q. And Exhibit 34, this is the home equity line of credit in a mortgage?

A. That's right.

Q. And the mortgage relates to what residence, what address?

A. The address is 35 Windy Hill Road, Sunfish Lake, Minnesota.

Q. And whose address is that?

A. Mr. O'Hagan's.

Q. And the mortgage has what date on the top right-hand corner?

A. The mortgage is made the 24th day of August, 1988.

[207]

Q. Okay. And then once that — The home equity line of credit is for what amount?

A. $400,000.

[208] * * * * *

Mr. O'Hagan did take the advance on this line of credit, and they were all — he used up almost the entire 400,000 by the end of August except for a couple thousand dollars worth.

* * * * *

MR. HAWKINS:

[220]

Q. His entire investments relating to Pillsbury in [221] July, August, September resulted in an entire profit to him of approximately 4.4 million?

A. That's right.

Q. Give or take, approximately?

A. Approximately.

Q. And his total investment was approximately eight hundred plus thousand dollars?

A. Right. Eight hundred eleven thousand, approximately.

Q. So his return on his money was about five hundred percent?

A. Let's see what it is. You're right. It is, approximately.

Q. Kind of return on your money you'd like to get on your investments, wouldn't it?

A. I think everybody would, Mr. Hawkins.

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

FOURTH DIVISION

Criminal No. 4–92–219

UNITED STATES OF AMERICA, *PLAINTIFF,*

v.

JAMES HERMAN O'HAGAN, *DEFENDANT.*

Volume VII
January 31, 1994

TRANSCRIPT OF TRIAL

HAD BEFORE THE HONORABLE
JAMES M. ROSENBAUM, and a Jury
Minneapolis, Minnesota

APPEARANCES:

For the Government	Christopher Bebel, Jon Hopeman
For the Defendant	Charles Hawkins
Reported By:	Dawn M. Sampson, RPR-CM

* * * * *

[TESTIMONY OF JAMES CONSIDEINE]

BY MR. HAWKINS:

[33]

Q. Now, directing your attention to approximately August of 1988, did there come a time where you were involved in a substantial trade in Pillsbury stock?

A. That's correct.

MR. BEBEL: Objection, irrelevant.

MR. HAWKINS: I'll connect it up, Your Honor.

THE COURT: Sustained.

BY MR. HAWKINS:

Q. In 1988, on or about August 18th, did you have a conversation with Jim O'Hagan regarding Pillsbury?

A. On August 18th?

Q. Yes, sir.

A. Ah, yes.

Q. What was the conversation that you had with Mr. O'Hagan about?

MR. BEBEL: Objection, hearsay.

THE COURT: Subject matter —

MR. HAWKINS: Subject.

THE COURT: — it may be permitted. Just, what was the nature of the subject? What were you talking about that day?

BY MR. HAWKINS:

Q. What was the nature —

A. I was talking about an order that I had in Pillsbury.

[34]

Q. From whom?

A. From one of my London accounts.

Q. How large?

A. The order or —

MR. BEBEL: Objection, irrelevant.

THE COURT: Overruled.

THE WITNESS: How large what, order?

BY MR. HAWKINS:

Q. Was the order from your client in London, England?

A. 250,000 shares.

Q. Options, stock, margin, how was it purchase?

A. Just — an order to buy 250,000 shares of Pillsbury at the market not held.

Q. What does at the market not held mean?

MR. BEBEL: Well, that's irrelevant, and we object.

THE COURT: Overruled.

THE WITNESS: At the market not held means that the trading department at Montgomery, ah, I take it back. It, it goes — it's technical, but it means that the order when it's given to the floor broker on the New York Stock Exchange is, it means that he has some discretion as to what price he wants to pay for it. But basically it means he has to participate in the volume, ah, as a stock trades, it's his — the market not held means he

has to be there, he has [35] to be buying the stock, but if for some strange reason it ran out, on the way up or way down, he has the discretion to hold off buying them. It basically means you want to complete the order the same day.

BY MR. HAWKINS:

Q. Unless you have some very unusual change in price?

A. Yes.

Q. Did you relate this information to Mr. O'Hagan at all?

MR. BEBEL: Objection, hearsay.

THE COURT: Overruled.

THE WITNESS: Ah, I told Mr. O'Hagan, after I had completed the order, that I'd had this large order, and bought a big block of stock for an account of mine.

BY MR. HAWKINS:

Q. When did that occur?

A. It occurred after I completed the order, I don't know what time of the day it was. It was on the 18th after I completed the order, I got back to my desk, and, ah, and had a conversation with Jim and mentioned that I was, you know, pretty happy because I had this large order that I'd executed that day.

Q. And you told him the amount of the order and the stock that it was in?

A. That's correct.

Q. Did you also identify where the purchaser of that stock [36] was from?

A. I —I think I told him I had an order from London, I didn't tell him the name of the account.

* * * * *

[81] [COLLOQUY BETWEEN COURT AND COUNSEL]

THE COURT: Okay. All right. So what did Grand Met lose?

[82]

MR. BEBEL: Well —

THE COURT: It's a simple question, counsel.

MR. BEBEL: Grand Met need not —

THE COURT: Counsel, my goodness, this case has been pending a year and a half.

MR. BEBEL: I'm sorry?

THE COURT: This case has been pending a year and a half.

MR. BEBEL: Grand Met lost the right to exclusive use of its information. And the testimony is that when there's —

THE COURT: But we already know for a moment, that the record says he didn't know it was Grand Met's information.

[84] * * * * *

THE COURT: So the loss, I'm trying to figure out — they were victimized by the fact that somebody took something off one of their tables. Picked up some [85]

information from.

MR. BEBEL: Well, they were victimized by Mr. O'Hagan taking information and misappropriating it into his own personal benefit. There's no specific evidence as to the manner in which he first obtained the evidence, to whether it was by conversation or by documentation.

[TESTIMONY OF PATRICIA KINNAHAN]

MR. HAWKINS:

[100]

Q. Now, did you ever make a recommendation to Mr. O'Hagan that he should purchase Pillsbury?

A. Yes.

Q. Did you recommend — when did that occur?

A. In August of 1988.

Q. Do you recall approximately what date?

[101]

A. The recommendation would have been on, I'm trying to think of the date, August 19th, I think.

Q. Did you recommend that he purchase that stock or solicit — solicit him to purchase whether it's stock or options through Janney Mont — through Janney Montgomery at that time?

A. I suggested that he purchase options at the time.

Q. Through you?

A. Yes.

[104] * * * * *

Q. What happened on August 18th?

A. On August 18th, I was watching the Dan Dorfman show when there was an announcement on air that Mr. Dorfman said that sources close to Grand Metropolitan were interested in acquiring Pillsbury.

Q. What did you think of that?

A. Well, I was excited, and a little bit nervous actu-

ally because I didn't have any position on Pillsbury and ran into the office first thing in the morning to see what this activity was going to be like, contacted Mr. O'Hagan because when I got in the office I didn't really see any further information on it. I thought there would be some news that would be out. Or something in the Wall Street Journal. There was — there was nothing on the 18th. I con —

Q. What did — what did you think Dan Dorfman's statement [105] was?

A. Well, you know, I'm a Washingtonian, and I hear every day of my life the sources close to the White House say, you know, umm, Mr. Highman will be leaving the Department of Justice, and a day later, guess what? Mr. Highman leaves the Department of Justice. So I thought something would be going on.

Q. What did you tell Mr. O'Hagan?

A. Well, I asked Mr. O'Hagan, first of all, I thought there may be something in your local paper. I was curious to see if we had some follow up locally on it, and there wasn't. And it intrigued me, because I waited all day and watched the news wires to see a statement from Pillsbury.

Q. What?

A. Well, generally when, umm, statements come out to that effect, if a Pills — if a company is really active, like not interested in being acquired, you usually have some kind of statement from them saying that, you know, we are going to remain independent or some kind of —

Q. They let their posture be known?

A. No. We never heard. We never heard from Pillsbury.

Q. Was that important to you?

A. Yes, it was very important. As a matter of fact, I would say that was probably the most important. Not what they said, but what they failed to say.

[106]

Q. So then you had a conversation with Mr. O'Hagan.

A. Yes. Then —

[105] * * * * *

Q. Prior to the conclusion of your conversations with Mr. O'Hagan on the 17th, 18th, and 19th, had any authority been given you to purchase Pillsbury options?

A. Yes.

Q. When did that occur?

A. On August 19th.

Q. When did you execute that authority to execute the trans —

A. On August 30th.

Q. Eleven days later?

A. Right.

[118] * * * * *

Q. You previously testified about this Dorfman matter on the 18th and then ran right into the office the next morning and were checking on things that were going on. Do you recall that?

A. Yes.

Q. What did you think what Dan Dorfman said was?

THE COURT: Asked and answered.

THE WITNESS: Right.

BY MR. HAWKINS:

Q. Did you tell Mr. O'Hagan what you thought in that regard?

A. I told Mr. O'Hagan I thought it was an announcement.

Q. By who?

A. Grand Metropolitan.

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

FOURTH DIVISION

Criminal No. 4–92–219

UNITED STATES OF AMERICA, *PLAINTIFF,*

v.

JAMES HERMAN O'HAGAN, *DEFENDANT.*

Volume VIII
February 1, 1994

TRANSCRIPT OF PROCEEDINGS

HAD BEFORE THE HONORABLE
JAMES M. ROSENBAUM, and a Jury
Minneapolis, Minnesota

APPEARANCES:

For the Government	Christopher Bebel, Jon Hopeman
For the Defendant	Charles Hawkins
Reported By:	Dawn M. Sampson, RPR-CM

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[TESTIMONY OF STUART EVANS]

MR. HAWKINS:

[11]

Q. Don't forget that. We'll come back to it. Now, back in July, you and Mr. O'Hagan talked about purchasing Pillsbury stock, correct?

A. Yes, sir.

Q. What was that conversation you had with him?

A. Ah, I —

Q. As best you recall?

A. As best I recall, I told Mr. O'Hagan, I said, ah, you know, I think there's something going on in this Pillsbury, ah, why don't — why don't we buy some of it, and, ah, I'm thinking about buying 5,000 shares for myself, and why don't you buy 5,000 shares, I think this guy, Kelly, but it was in the period of time when the takeover, ah, it was takeover [12] mania. It was Kraft had been, ah, played on, several of the major food companies had been targeted as takeovers, if not actual takeovers, but as rumor for takeover. So I told Jim, I says, why don't, why don't we buy, you know, why don't we buy this thing and see if, you know, any play comes into it. And, umm, so he said, okay, sure, if I got the money, he said, ah, let's buy it, and I'll buy 5,000, you buy 5,000. So we did. We bought 5,000 shares apiece, and, umm, I thought basically nothing of it.

Q. Was it unusual for Mr. O'Hagan to buy 5,000 shares of stock?

A. No, sir.

[13] * * * * *

Q. What did you base your solicitation on back in July, as best you recall?

A. A takeover.

Q. Of what?

A. Of Pillsbury.

[14] * * * * *

Q. Did there come a time when you talked to Mr. O'Hagan about purchasing options?

A. Yes, sir.

Q. When did that occur?

A. This was in the same period of time.

Q. Approximately when?

A. Approximately, ah, August the first.

[28] * * * * *

Q. And how many September 40s did Mr. O'Hagan purchase between August 18th and August 24th, taking into account that the settlement date's reflected in the account statement?

A. It appears that 500 call options in Pillsbury that were struck, ah, September 40s, would have been purchased, 500. 500 calls.

Q. Now, were those September 40s in your opinion solicited or unsolicited?

A. I would consider 'em solicited.

* * * * *

Q. Had you talked to Mr. O'Hagan previously about

the purchase of options?

A. Ah, yes, sir.

[31] * * * * *

Q. So the first purchase of 500 September 40s occurred between August 18th and August 25th, correct?

A. Yes, sir.

Q. And during that —and that was for 500 shares of September 40s?

A. 500 calls.

Q. Right? I apologize. 500 contracts, correct?

A. Yes, sir.

Q. And that 500 contracts is basically the same thing, or would cover the same option for that 5,000 shares of common stock. They'd be a hundred shares per contract, correct?

A. 500, ah — no. 50 is 5,000 shares. 500 would be 50,000 shares.

Q. Okay. So he had 50,000 shares in the options?

A. That's correct.

Q. And he had 5,000 shares in common stock?

A. Yes, sir.

[45] * * * * *

Q. When these contracts were purchased, whether it's October 40s, November 45s, that much purchased through you, who recommended what month and strike price should be purchased?

A. Generally I did.

MR. HAWKINS: Can I have a moment, Your Honor?

THE COURT: Yes, sir.

(Pause.)

BY MR. HAWKINS:

Q. Now, the order for the October, 2,000 October 40 contracts, do you consider that solicited or unsolicited, sir?

A. It was solicited.

Q. By whom?

A. By me.

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

FOURTH DIVISION

Crim. No. 4-92-219

UNITED STATES OF AMERICA, *PLAINTIFF,*

vs.

JAMES HERMAN O'HAGAN, *DEFENDANT.*

Volume X
February 3, 1994

TRANSCRIPT OF TRIAL

HAD BEFORE THE HONORABLE
JAMES M. ROSENBAUM, and a Jury
Minneapolis, Minnesota

APPEARANCES:

For the Plaintiff	Christopher Bebel, Jon Hopeman
For the Defendant	Charles Hawkins
Reported By:	Dawn M. Sampson, RPR-CM

* * * * *

[TESTIMONY OF PAUL WALSH]

MR. HAWKINS:

[3]

Q. During 1988, was there any business development that was being looked at by Grand Metropolitan?

A. Yes. We were in the process of exiting our hotel division. If I can just go back a little bit before that, starting in 1987, we fundamentally decided to refocus our business, particularly in the United States, whereby we divested ourselves of many businesses that we felt were nonstrategic, one of which was the hotel division, and focused on acquiring a branded food company.

[4]

Q. And that strategy commenced back in 1987?

A. Yes.

Q. Now, at that time, were there any specific plans entered into by Grand Met in identifying individual companies or branded food companies that they may be interested in?

A. Probably in late '87, we had a list of companies that were of interest.

[7] * * * * *

Q. Now, there came a time — let me go back. Did [8] Intercontinental Hotels play any role in your plans that you were analyzing?

A. Very much so.

Q. Would you explain to the jury how Intercontinental Hotels played a role in your analysis?

A. We had decided strategically to withdraw from hotels, which would mean a sale of that entity. We estimated at that point in time that the value of that property could be anything like 1.8 to $1.3 billion. Therefore, recognizing the size of the Pillsbury acquisition, the sale of Intercontinental Hotels would provide a lot of the cash to fund the acquisition of Pillsbury.

Q. What would have happened to your plan if you were unable to obtain a purchaser for the sale of the Intercontinental Hotels?

A. Had we not found a purchaser of our hotel division, we would have delayed the acquisition of Pillsbury until we found such a purchaser.

[17] * * * * *

Q. Turning back to the Intercontinental Hotel sale for a minute, did there come a time when you traveled to Tokyo, Japan?

A. Yes.

Q. Approximately when did you leave?

A. Approximately the 22nd, 23rd of September.

Q. When did you return?

A. I returned, I think it was the 1st of October.

Q. What was your purpose for going there?

A. I was negotiating the sale of Intercontinental Hotels to — with the final buyer, which was the Salod Group of Japan.

Q. In regard to your trip and its purpose, prior to your leaving, did you have a deal for the sale of Intercontinental Hotels?

A. No.

Q. Did you have a deal when you came back?

A. Yes.

[20] * * * * *

Q. Now, when did you first learn that a tender offer indeed would be made for Pillsbury?

A. I learned when I returned from Tokyo.

Q. What date was that?

A. It was the Saturday. It would be the 1st, the 1st of October.

Q. Approximately two or three days, actually, before the tender offer?

[21]

A. Yes.

Q. Now, I'm showing you what's been received in evidence as Defendant's Exhibit 11. Do you recognize that, sir?

A. Yes.

Q. What is it, sir?

A. It's a newspaper article.

Q. From where?

A. From the UK Press.

Q. Now, under the caption with the photograph, it says Sheppard looking at acquisition which would fundamentally change Grand Met?

A. Yes.

Q. That's dated the 18th of September, correct?

A. That is written in by hand.

Q. Looking at acquisition, would you characterize that as being a fair statement?

A. That would be a very fair statement, yes.

Q. Had a decision been made about an acquisition at that point?

A. Eighteenth of September. A decision had been made in principle that we would like to acquire Pillsbury. However, the decision to actually launch the hostile tender offer had not been taken.

[26] * * * * *

Q. Does that refresh your recollection as to what the date was that the $60 recommendation was made?

A. Yes.

Q. What date was that, sir?

A. September the 15th.

Q. 1988?

A. 1988.

Q. Now, what was eventually paid for Pillsbury?

A. $66 per share.

[36] * * * * *

Q. As a result of your understanding about whatever obligations there were, what information did you believe was necessary specifically to be maintained confidential?

* * * * *

A. Well, in essence, the target name. We needed to keep Pillsbury confidential. We needed to keep the timing confidential, and we certainly needed to keep the price [37] confidential, and our potential actions after the acquisition, we needed to keep confidential.

Q. So excluding what your plans were after you made the acquisition, price, time and identity, correct?

A. Yes.

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

FOURTH DIVISION

Crim. No. 4-92-219

UNITED STATES OF AMERICA, *PLAINTIFF,*

vs.

JAMES HERMAN O'HAGAN, *DEFENDANT.*

Volume XI
February 7, 1994

TRANSCRIPT OF PROCEEDINGS

HAD BEFORE THE HONORABLE
JAMES M. ROSENBAUM, and a Jury
Minneapolis, Minnesota

APPEARANCES:

For the Government:	Christopher Bebel Jon Hopeman
For the Defendant:	Charles Hawkins
Reported By:	Dawn M. Sampson, RPR-CM

* * * * *

[TESTIMONY OF DENNIS MATHISEN]

[MR. HAWKINS:]

[26]

Q. I'm showing you what's been received in evidence as Defendant's Exhibit 9. Have you seen that, sir?

A. I have.

Q. And what is that?

A. This is a, ah, a little piece that occurs in a magazine called Mergers and Acquisitions Week, and, umm, it, ah, refers to — there's an article that refers to, umm, Grand Met's, ah, acquisition strategy, ah, with respect to, ah, with respect to Pillsbury, and the reference to its disposition, its proposed disposition of its hotel operation.

Q. What's the relevancy of that article in regard to the disposition of its hotel chain?

A. Well, I think, ah, it, ah, refers to the requirement that, ah, Grand Met, ah, must raise a fair amount of cash in order to engage in the acquisition of Pillsbury. And the raising the cash is going to occur, umm, through the sale and disposition of its, ah, its hotel chain.

Q. Based upon your review of that document, as well as others, do you have an opinion as to whether or not Grand Met was successful in keeping its target, or acquisition target confidential?

[27]

MR. BEBEL: Objection, irrelevant, foundation.

THE COURT: Sustained. 403.

BY MR. HAWKINS:

Q. In Defendant's Exhibit 9, is there an identity of a target?

A. Ah, yes.

Q. What's the target?

A. Pillsbury.

Q. And is there any reference to this information having been provided by analysts?

A. Yes.

Q. And would you tell the jury what the relevancy is of analysts having provided that information?

A. Well, analysts are constantly looking at a company, umm, for clues or indications of what is, ah, ah, going to produce, ah, revenue and profit and, umm, so they keep a very close eye on the company. They talk to people, they talk to insiders as often as they possibly can. They talk to, umm, not only the president of the company, but they talk to employees, and, ah, that's how they obtain information from the inside of the company.

Q. Does it say in that article where the analysts are from?

A. UK.

Q. Now, using August 22nd, which is the date of the Defendant's Exhibit 9 article, and September 30th as the [28] date of the execution of the contract for the sale of the hotels, using those two parameters, do you have an opinion as to whether between August 22nd, 1988, and September 30th, 1988, there was any material nonpublic information that would have been relevant to an investor?

MR. BEBEL: Objection, foundation, speculation, 403.

THE COURT: You may answer.

THE WITNESS: I'm not aware of, ah, any such information.

[29] * * * * *

Q. Are you aware of any condition precedent, that makes the time frame between August 22nd, 1988, and September 30th, 1988, immaterial for purposes of there being any nonpublic information?

A. In my view, the condition precedent is the sale and disposition of the hotel chain.

* * * * *

[GOVERNMENT CLOSING ARGUMENT]

MR. BEBEL:

[88]

And he just decides to embark on a different type of stealing. Instead of stealing money, he steals another form of profit, confidential business information. Grand Met's secret plans.

And when you're thinking about that theft of confidential business information, think about the testimony of Tom Tinkham. Tinkham's testimony shows that the defendant knew about Pillsbury's plans — strike that — about Grand Met's plans, and it shows that the defendant knew Pillsbury was the object of those plans.

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

FOURTH DIVISION

Criminal No. 4–92–219

UNITED STATES OF AMERICA, *PLAINTIFF,*

vs.

JAMES HERMAN O'HAGAN, *DEFENDANT.*

Volume XII
February 8, 1994

TRANSCRIPT OF PROCEEDINGS

HAD BEFORE THE HONORABLE
JAMES M. ROSENBAUM, and a Jury
Minneapolis, Minnesota

APPEARANCES:

For the Government	Christopher Bebel, Jon Hopeman
For the Defendant	Charles Hawkins
Reported By:	Dawn M. Sampson, RPR-CM

* * * * *

[JURY CHARGE]

* * * * *

[THE COURT:]

[20]

Now I went over with you those first 20 counts, and those counts are mail fraud, so let's look at mail fraud. Counts 1 through 20 of the indictment charge the defendant with mail fraud in violation of Title 18, Section 1341 of [21] the United States Code. That title and section is just chapter and verse the way they catalog things in the U.S. Code Section 1341 of Title 18 of the United States Code provides, in part, and here I read exactly: Whoever having devised any scheme or artifice to defraud for the purpose of executing such scheme or artifice, knowingly causes to be delivered by mail, according to the direction thereon, any mail, shall be guilty of an offense against the United States.

Now, then, I told you I would tell you about essential elements. Now I'm going to tell what you they are, and then in a minute I'm going to tell you the things that comprise each of the elements. So you see how this all fits together.

The crime of mail fraud has four essential elements, and they are: 1) the defendant voluntarily and intentionally devised or made up a scheme to defraud Grand Met or Dorsey & Whitney out of money, property, or property rights by purchasing Pillsbury securities while in possession of material nonpublic information, and using the profits obtained therefrom to conceal his previous use and possession of client trust funds. That's the first element; 2) that the defendant did so with the intend to defraud; 3) that it was reasonably foreseeable that the mails would be used, or that the mails were used in the furtherance of some [22] essential step in the scheme.

The phrase scheme to defraud includes any plan or course of action intended to deceive or cheat another out of money, property, or property rights.

To act with intent to defraud means to act knowingly, and with the intent to deceive someone for the purposes of causing some financial loss of property or property rights to another, or bringing out a financial gain to one's self, or another, to the detriment of a third party.

The words to defraud commonly refer to wronging one in his property rights by dishonest methods or schemes, and usually signify the obtaining of something by — of value by trick, deceit, or by overreaching.

The term property rights, as used in the mail fraud statute, includes any property right which has a value, not necessarily a monetary value, to the owner of that property right.

It is not necessary that the mails — excuse me — it is not necessarily that the use of the mails by the defendant himself be contemplated, or that the defendant do any actual mailing or specifically intend that the mail be used. It is sufficient if the mails were in fact used to carry out the scheme, and the use of the mails by someone was reasonably foreseeable.

Under the mail fraud statute, each separate use of the [23] mails, in furtherance of the scheme to defraud, constitutes a separate offense. It is not necessary that the government prove all of the details alleged in the indictment concerning the precise nature, or the purpose of the scheme, or that the alleged scheme actually succeeded in defrauding anyone, or that the use of the mail was intended as a specific or exclusive means of accomplishing the alleged fraud. Now, ladies and gentlemen, that's mail fraud. And that's the way the law defines mail fraud.

Now I want to swing back with you to the indictment again. In Counts 21 — I just went over Counts 1 through 20, and you'll apply that set of instructions to that part of the indictment. And you should review again the indictment, and that is the counts for securities fraud. Those are 21 through 37. In Counts 21 through 37, it is claimed that Mr. O'Hagan used the information which came to him to work a fraud on Grand Met and Dorsey & Whitney. Now, according to the indictment, he worked this fraud by purchasing Pillsbury stock and options while he was in possession of material, nonpublic information concerning Grand Met's upcoming tender offer for Pillsbury securities. The dates of these transactions, according to the indictment, were between August 29, 1988, and September 21, 1988.

And I think I'm going to stand up and stretch, have a [24] glass, a drink of water, and then we'll go back into the elements of securities fraud.

[26] * * * * *

Okay. Now we shift to the substance of Counts 21 through 54. All of those counts charge the defendant with a particular type of securities fraud, and that is known as insider trading. Counts 21 through 37, which I'll go over with you in a moment, charge securities fraud under another chapter and title, that is Title 15 of the United States Code Section 78JB, and Title 17 Code of Federal Regulations, Section 240.10(b)(5). While Counts 38 through 54 charge a different type of securities fraud under Title 15 United States Code Section 78N, part E, and Title 17, Code of Federal Regulations Section 240.14(e)(3) A.

Now you know why you have a handwritten, or typed copy of those in front of you, ladies and gentlemen. Nobody gives that instruction off the top of their head.

Let me now focus with you on Counts 21 through 37. Title 15 United States Code Section 78J Section B, as charged in 21 through 37 provides as follows, and again I quote directly: It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails to use or employ in connection with the purchase or sale of any securities, any manipulative or deceptive device or [27] contrivance in contravention of rules the Securities and Exchange Commission may prescribe for the protection of investors. That's the statute.

Title 17, Code of Federal Regulations, Section 240.10(b)(5), which is promulgated by the Securities and Exchange Commission again, says: It shall be unlawful for any person directly or indirectly, by the use of or any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, A, to employee any device, scheme, or artifice to defraud, or to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit on any person in connection with the purchase or sale of any security. With respect to these Counts 21 through 37, illegal insider trading exists when a defendant, through a relationship of trust and confidence, gains access to material, nonpublic information intended to be used only for corporate purposes, and the defendant trades in the stock of a publicly traded company using information which is not available to the public.

As for Counts 1 through 37, the offense of insider trading has the following elements, and here there are five elements. First, that the defendant gained access to, and then misappropriated material, nonpublic information, which was to be used only for Grand Met's purposes through a [28] relationship of trust and confidence; second, that the defendant traded in Pillsbury securities

while in possession of nonpublic information obtained as a result of the confidential relationship; third, the information was material; fourth, the defendant used the information to trade securities with the intent to defraud. I'm going to read that one again. Fourth, the defendant willfully used the information to trade securities with the intent to defraud; fifth, the defendant directly or indirectly used any means or instrumentalities of interstate commerce, the mails, or any facility of a national securities exchange in furtherance of his fraudulent conduct.

Now, let me focus with you on each of those elements. With respect to the first of those elements, in order for you to find that the defendant unlawfully traded in Pillsbury securities, you must find that the defendant had a duty to either Grand Met or the Dorsey & Whitney law firm. Any relationship — sorry — any duty which the defendant owed to Grand Met must have arisen from a relationship of trust and confidence, which may have existed between Grand Met and the Dorsey & Whitney law firm as a result of any attorney-client relationship which may have existed. Similarly, any duty which O'Hagan owed to the Dorsey & Whitney law firm, must have arisen from a relationship of trust and confidence which may have existed between Mr. [29] O'Hagan and Dorsey & Whitney while Mr. O'Hagan was a Dorsey & Whitney partner.

With respect to Grand Met and the Dorsey & Whitney law firm, the question is whether either or both of those entities expected the defendant to keep in confidence any information which he obtained in a legal capacity. Did either or both of them expect him to refrain from using such information in connection with his personal securities trading activities? Either or both of those entities must have expected the defendant to

keep the information confidential, and must not use it for his personal benefit, or at least the relationship must have implied such a duty. The mere possession of nonpublic or inside information does not impose a duty on an individual to disclose before trading.

Therefore, with respect to these counts, 21 through 37, in order to find that Mr. O'Hagan engaged in insider trading, you must first find that there existed some special relationship, as I have just explained it, which created that duty. With respect to those counts, it is the breach of that duty that provides the basis for these charges in the indictment.

Unless otherwise agreed, an agent has a duty to the principal not to use or to communicate information confidentially obtained by him from the principal. This [30] includes information acquired by him during the course of or on account of his agency, or in violation of his duties as an agent. This rule would not apply, however, if the information is a matter of general knowledge. You are instructed, and when I say you are instructed, that means it is the law and not a matter for dispute, that a partner in a law firm is an agent of the firm. The firm's employees and partners are agents of the law firm's client.

During the course of your deliberation concerning Counts 21 through 37, these counts we're looking at now, you must now decide whether the defendant owed a duty of trust and confidence to Grand Met, the Dorsey & Whitney law firm, or to both. If you find that a duty was owed, you must also decide whether the defendant breached that duty of trust and confidence to Grand Met, the Dorsey & Whitney law firm, or to both. The government is not required to prove that the defendant breached a duty of trust and confidence to both Pills —

I'm sorry, my heavens — to both Grand Met and the Dorsey & Whitney law firm. However, as for each of these counts, in order to convict, each juror must agree with each of the other jurors that the defendant breached a duty to Grand Met, the Dorsey & Whitney law firm, or both. In other words, there cannot be a conviction, if, for example, one half of you believe that there was a duty owed to Grand Met, and the other half believed there was a duty owed to Dorsey [31] & Whitney. There must be a meeting of minds between you and among you whether there was a breach of duty towards Grand Met, toward Dorsey & Whitney, or toward others. What I'm saying, of course, remember I told you that — your verdict, I'll tell you again, your verdict's going to have to be unanimous. You can't just think, well, you owed a duty to somebody. You have to decide was there a duty, to whom, it can be one, either, or both, and then make that decision as to each count that you deliberate on and make that decision as part of your decision making process.

The federal securities laws define a security as any stock option on a security, et cetera. You are instructed as a matter of law that Pillsbury common stock, and any option on Pillsbury common stock, including the call option, is a security.

The government must also prove that the material information possessed by the defendant was nonpublic, as the law defines it. Nonpublic means not generally available to the public. The information of a business, company is nonpublic if the company has not publicly announced, or revealed the information or disclosed it in publicly available filings, announcements, or releases, or if the company has not disclosed it to entities whose business it is to make public disclosure, such as the press, or security analysts.

[32]

Whether information is public or it is nonpublic depends primarily on whether it is generally available to the public. If the information has previously been included in a company's public filings or disclosed in public announcements or press releases, or discussed with financial analysts, it is public information. If, on the other hand, the information is held in confidence by the company, then it is nonpublic, even though there may be rumors circulating among the general public on the subject, and even though individuals who are privy to the information may improperly disclose it to other persons.

You must also decide whether the information traded on by the defendant was material information. Material information means information that a reasonable investor would consider important when deciding whether to buy, sell, or hold Pillsbury stock. Information is material when there is substantial likelihood that a disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly changed the total mix of information made available.

The test, then, is whether a reasonable — I'm sorry — a prudent investor would be influenced to change or to take a market position if he or if she was in possession of this information. It is up to you to decide, based on all of the relevant evidence, whether the information was material. [33] That's the third element of the securities charge.

The fourth element which the government must establish is that defendant O'Hagan acted with intent to deceive, manipulate, or defraud. Intent ordinarily may not be proven directly, there is just simply no way of fathoming or scrutinizing the workings of the human mind. But you may infer the defendant's intent from the

surrounding circumstances. You may consider any statements made or done or statements which were omitted by the defendant, and all other facts and circumstance in evidence which indicate to you his state of mind. You may consider it reasonable to draw the inference and find that a person intends the natural and the probable consequences of acts which are knowingly done or knowingly omitted. As I have said, it is entirely up to you to decide what facts to find from the evidence.

In the context of Counts 21 through 37, intent to deceive, manipulate, or defraud may be established by proof that, A, the defendant was aware the information had been provided to him in reliance on a confidential relationship; or B, that the defendant had actual knowledge or undisclosed material information; C, that the defendant knew that the information was material; and D, the defendant knew that the information was nonpublic. Furthermore, an erroneous subjective belief that the law has not been violated is not [34] a defense to insider trading if the defendant was aware of the factors which I have just gone over.

Also, with respect to element number four, the government has alleged that the fraudulent context — I'm sorry — that the fraudulent conduct occurred in connection with the purchase or sale of securities. The government must prove beyond a reasonable doubt that the defendant used the material, nonpublic information, if any, when he purchased the Pillsbury securities.

The fifth element which the government must establish is that the defendant directly or indirectly used means or instrumentalities of interstate commerce, the mails, or any facility of a national securities exchange in furtherance of his fraudulent conduct.

The term interstate commerce, as used in these

instructions, means trade or commerce in securities or any transportation or communication relating to such trade or commerce among the several states. This element of the charge may be established if the government proves beyond a reasonable doubt that any means or instrumentality of interstate transportation or communications, and those would include the mails, or the facilities of a national securities exchange were in fact used in the scheme, or that such use was reasonably foreseeable.

In this regard, however, it is not necessary for the [35] government to prove that the defendant personally used the means or instrumentalities of interstate commerce or the mails, or used a national exchange or that such use was contemplated or intended by anyone who was involved in the scheme. It is sufficient for the government to prove that the defendant set forces in motion which foreseeably resulted in such a use. The matter, the material, or information mailed, transported or communicated or traded on any exchange need not itself contain a fraudulent representation or request money, but must be part of the overall scheme.

An intrastate, that means within the borders of a state, or an interstate, across the borders of a state, telephone call constitutes the use or the means of instrumentalities of interstate commerce as they are defined in the securities law.

Now, ladies and gentlemen, we have finished with our instructions on 21 through 37. And I will go with you and focus on those counts which remain, on Counts 38 through 54. Go back to the summary of the indictment again.

In Counts 38 through 54, the indictment charges that Mr. O'Hagan obtained material information which was

not public information, and then used it to trade in Pillsbury securities. In those counts, it is claimed that Mr. O'Hagan purchased these securities after Grand Met had taken [36] substantial steps toward the making of a tender offer. It's claimed that he acquired this information through his employment at Dorsey & Whitney. It is claimed that he used this information before it was available to the public and that he did not release this information when it came to his attention. Okay. That's another set. That's the — ah, that's the use after taking substantial steps. Let's focus on that. Again, you will read the indictment, I know, with a good deal of care.

Counts 38 through 54 charge that the defendant violated title 15 of the United States Code Section 78N, part E, and Title 17 Code of Federal — Federal Regulations, Section 2:50.14(e)(3)(A), and that is commonly known as Rule 14(e)(3)(A). Commonly known. Just the other day I'm sure you were talking about 14(e)(3)(A).

It's not necessary that you did.

Title 15, United States Code Section 78N, part E, as charged in Counts 38 through 54 provides in the part that's important here as follows: It shall be unlawful for any person to engage in any fraudulent, deceptive, or manipulative acts or practices in connection with any tender offer.

Title 17 of the Code of Federal Regulations, Section 2:50.14(e)(3)(A), which is promulgated, that means put out by, the Securities and Exchange Commission provides in its [37] elevant part, that any person who has taken a substantial step or steps to commence or has commenced a tender offer — I'm sorry — if any person has taken a substantial step or steps to commence or has commenced a tender offer, it shall constitute a

fraudulent, deceptive, or manipulative act or practice within the meaning of Section 14(e) for any other person who is in possession of material information relating to such tender offer, which is information he knows is nonpublic and which he knows has been acquired directly or indirectly from, one, the offering person, or two, any officer, director, partner, or employee, or any other person acting on behalf of the offering person, to purchase or sell or cause to be purchased or sold any of such securities or any option or right to obtain or dispose of any of the foregoing securities, unless within a reasonable time prior to the purchase or sale of such information, and its source, are publicly disclosed by press release or otherwise.

That is a large bite to chew, as you can tell as you look at it, so we break it down again. The federal securities law define the word person as a natural person, a company, et cetera. I instruct you as a matter of law, and again it is not subject to question, but you must accept it, that Grand Met is a person within the meaning of the federal securities laws for these purposes.

The provisions governing Counts 38 through 54, then, [38] cover the specific situation of insider trading with respect to tender offers. With respect to these counts, illegal insider trading exists when a corporation has taken a substantial step toward the commencement of a tender offer, and the defendant obtains material nonpublic information concerning that tender offer, and the defendant, knowing that this information came from the corporation, invests in securities using material nonpublic information.

As to Counts 38 through 54, there are six elements. First, that Grand Met has taken a substantial step or steps to commence a tender offer for the stock of

Pillsbury; second, that the defendant was in possession of material information relating to this tender offer, and the defendant knew the information was material; third, the information was nonpublic and the defendant knew that the information was nonpublic; fourth, that the defendant knew that the information had been acquired directly or indirectly from a tender offeror, or any officer, director, employee, or other person or firm acting on its behalf; fifth, that the defendant purchased or caused to be purchased Pillsbury common stock or options on Pillsbury common stock using this material, nonpublic information; sixth, the defendant willfully purchased or caused to be purchased the Pillsbury securities with the intent to defraud.

Ladies and gentlemen, I have previously gone over a [39] number of instructions and definitions which will guide your analysis as to whether or not the information was material, and whether or not it was nonpublic. I also instructed you with regard to intent. While focusing on 38 through 54, those same instructions will apply.

Another concept that is the same for 21 through 37 and 38 through 54 is the in connection with requirement. For Counts 38 through 54, you must find that the fraudulent conduct occurred in connection with the tender offer for Pillsbury stock. So I've defined those things for you, and those are consistent definitions right on through. I will now address, however, those elements of Counts 38 through 54 which differ from those which relate to the previous or other counts.

With respect to Counts 38 through 54, you must find that Grand Met had taken one or more substantial step to commence its tender offer for Pillsbury stock at the time that O'Hagan had purchased the relevant Pillsbury securities. It is not necessary for a bidder to make a tender offer for you to find that substantial steps towards such an offer have been taken or made. Nor is it necessary that you find that the defendant knew that the substantial steps had been taken. It is enough that you find one or more substantial steps were in fact taken.

The fourth of the elements of Counts 38 through 54 is [40] that the defendant knew that the information about Grand Met's plan to make a tender offer for Pillsbury stock had been acquired directly or indirectly from Grand Met or any officer, director, employee, or other person acting on Grand Met's behalf. The government alleges that the defendant knew that the information had been acquired from either Grand Met or from Tom Tinkham, or Thomas Tinkham.

If you find that the defendant acquired the information from Thomas Tinkham in order to satisfy the fourth element, you must also find that the defendant knew Mr. Tinkham was working on Grand Met's behalf, such that the defendant knew that the information was acquired from Grand Met. The government is not required to prove that the defendant knew that the information had been acquired directly or indirectly from both Grand Met and Thomas Tinkham. However, as for each of these counts, in order to convict, each juror must agree with each other juror, that the defendant knew that the information had been acquired directly or indirectly from Grand Met, from Thomas Tinkham, or from both. And again, there must be a meeting of minds among the jurors as to whom or what was the source of the information. It can be Tinkham, it can be Grand Met, it can be both. Six and six, three, three, and three — no, that math is lousy. Four, four, and four, or any other combination doesn't work. It's got to be 12/0 that it came from [41] one, another or both. Okay.

It is not an element of the offenses which are charged in this indictment that the defendant knew the actual identity of the company making the tender offer. It's sufficient that they knew there was a tender offeror. Whether or not the name was attached to the tender offeror is not an essential element of the proofs.

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

FOURTH DIVISION

Criminal No. 4-92-219

UNITED STATES OF AMERICA, *PLAINTIFF,*

v.

JAMES HERMAN O'HAGAN, *DEFENDANT.*

Sentencing
October 27, 1994

TRANSCRIPT OF PROCEEDINGS
HAD BEFORE THE HONORABLE
JAMES M. ROSENBAUM, and a Jury
Minneapolis, Minnesota

APPEARANCES:

For the Government	Christopher Bebel
For the Defendant	Charles Hawkins
Reported By:	Dawn M. Sampson, RPR-CM

* * * * *

[24] [DENIAL OF MOTION FOR AQUITTAL]

THE COURT: Mr. O'Hagan, this is probably going to take a couple of minutes if you feel like you'd rather sit, you may do that also. I begin, for the record, by denying [25] the post trial motions for acquittal. I find that the law was proper, the prosecution was properly conducted under the law, and the findings of the jury's determinations are supported in the record. This is as difficult a case in sentencing as I have ever had in my career. In some ways, and I mean it, Mr. O'Hagan, I have found it as affecting a case as obviously your counsel has. Unlike many — the lawyers in town, it was not part of my practice to have done work in areas that intersected with yours, and the first time I ever met you, I think you conducted a case in front of me. And did so well.

[27] * * * * *

But all of those things, and I attempt to balance them as well as I am able, I have attempted to take into consideration, as I've made the findings which I will now announce vis-a-vis first of all the Guidelines, and then as I've attempted to fashion the sentence which I will impose. First, it is clear that the jury has found you guilty of all 57 counts of an indictment. That indictment contained 20 counts of mail fraud, 34 of securities fraud, and three of money laundering. The Court is convinced, as I've indicated, that that verdict is supported by the evidence.

AO245S (D.Minn. Rev. 3/95) Sheet 1 - Judgment in a Criminal Case

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

UNITED STATES OF AMERICA

v.

JAMES HERMAN O'HAGAN

JUDGMENT IN A CRIMINAL CASE
(For Offenses Committed On or After November 1, 1987)

Case Number: 4-92-CR-219(01)
Def.Counsel: Charles Haskins

The defendant was found guilty on Counts 1 through 57 after a plea of not guilty.

Accordingly, the defendant is adjudged guilty of such counts, involving the following offenses:

Title & Section	Nature of Offense	Count
18 U.S.C. § 1341	Mail Fraud	1 - 20
15 U.S.C. §§ 78j(b) & 78ff(a) and 17 C.F.R. § 240.10b-5	Securities Fraud	21 - 37
15 U.S.C. §§ 78o(c) and 78ff(a) and 17 C.F.R. § 240.14e-3(a)	Securities Fraud	38 - 54
18 U.S.C. § 1957	Money Laundering	55
18 U.S.C. § 1956(a)(1)(B)(i)	Money Laundering	56 - 57

The defendant is sentenced as provided in pages 2 through 5 of this judgment. The sentence is imposed pursuant to the Sentencing Reform Act of 1984.

It is ordered that the defendant shall pay a special assessment of $2,850, for Counts 1 - 57, which shall be due immediately.

It is further ordered that the defendant shall notify the United States Attorney for this district within 30 days of any change of name, residence, or mailing address until all fines, restitution, costs, and special assessments imposed by this judgment are fully paid.

Defendant's SSN: 469-34-2625

Defendant's DOB: April 14, 1936

Defendant's Mailing Address:
35 Windy Hill Road
Sunfish Lake, MN 55077

Dated: October 27th, 1994

JAMES M. ROSENBAUM, U.S. District Judge
Sentence Imposed: October 27, 1994

Defendant: JAMES HERMAN O'HAGAN
Case Number: 4-92-CR-219(01)

Judgment: Page 2 of 5

IMPRISONMENT

The defendant is hereby committed to the custody of the United States Bureau of Prisons to be imprisoned for a term of 41 months.

The Court recommends a federal correctional institution or a jail-type facility in Duluth, Minnesota, for service of sentence. The Court notes that Duluth is appropriate since defendant was a model prisoner who made substantial contributions to society, in particular to fellow state prisoners, since his state court conviction.

The defendant shall surrender to the United States Marshal for this district.

The defendant shall surrender for service of sentence at the institution designated by the Bureau of Prisons.

RETURN

I have executed this judgment as follows:

_____

_____

_____

_____

Defendant delivered on _____ to _____

at _____, with a certified copy of this judgment.

_____
United States Marshal

By _____
Deputy Marshal

Defendant: JAMES HERMAN O'HAGAN
Case Number: 4-92-CR-219(01)

Judgment: Page 3 of 5

SUPERVISED RELEASE

Upon release from imprisonment, the defendant shall be on supervised release for a term of 3 years.

While on supervised release, the defendant shall comply with all federal, state, and local laws; comply with all rules and regulations of the probation office; abide by the standard conditions of supervised release as recommended by the sentencing commission; not possess any firearms or other dangerous weapons; shall comply with the standard conditions that have been adopted by this court (set forth below); and shall comply with the following additional conditions: defendant shall pay not less than $500 per month alimony to his former wife.

The Court directs that the probation office furnish to the defendant a written statement of all of the conditions of his supervised release.

STANDARD CONDITIONS OF SUPERVISION

While the defendant is on supervised release pursuant to this Judgment:

1) The defendant shall not leave the judicial district without the permission of the court or probation officer.
2) The defendant shall report to the probation officer as directed by the court or probation officer and shall submit truthful and complete written report within the first five days of each month.
3) The defendant shall answer truthfully all inquiries by the probation officer and follow the instructions of the probatio officer.
4) The defendant shall support his or her dependents and meet other family responsibilities.
5) The defendant shall work regularly at a lawful occupation unless excused by the probation officer for schooling, training or other acceptable reasons.
6) The defendant shall notify the probation officer within seventy-two hours of any change in residence or employment.
7) The defendant shall refrain from excessive use of alcohol and shall not purchase, possess, use, distribute or administe any narcotic or other controlled substance, or any paraphernalia related to such substances.
8) The defendant shall not frequent places where controlled substances are illegally sold, used, distributed, or administere
9) The defendant shall not associate with any persons engaged in criminal activity, and shall not associate with any perso convicted of a felony unless granted permission to do so by the probation officer.
10) The defendant shall permit a probation officer to visit his or her at any time at home or elsewhere and shall permi confiscation of any contraband observed in plain view by the probation officer.
11) The defendant shall notify the probation officer within seventy-two hours of being arrested or questioned by a l enforcement officer.
12) The defendant shall not enter into any agreement to act as an informer or a special agent of a law enforcement agenc without the permission of the court.
13) As directed by the probation officer, the defendant shall notify third parties of risks that may be occasioned by t defendant's criminal record or personal history or characteristics, and shall permit the probation officer to make suc notifications and to confirm the defendant's compliance with such notification requirement.

Defendant: JAMES HERMAN O'HAGAN
Case Number: 4-92-CR-219(01)

Judgment: Page 4 of 5

FINE

The defendant shall pay a fine of $150,000. This fine includes any costs of incarceration and supervision. This fine shall be paid as directed by the Probation Office.

The Court has determined that the defendant does not have the ability to pay interest, and it is accordingly ordered that the interest requirement is waived.

If the fine is not paid, the court may sentence the defendant to any sentence which might have been originally imposed. See 18 U.S.C. §3614.

Defendant: JAMES HERMAN O'HAGAN
Case Number: 4-92-CR-219(01)

Judgment: Page 5 of 5

STATEMENT OF REASONS

The Court adopts the factual findings and guideline application in the presentence report, except as stated below:

Guideline Range Determined by the Court:

Total Offense Level:	24
Criminal History Category:	I
Imprisonment Range:	41 to 51 months
Supervised Release Range:	3 to 5 years
Fine Range:	$4,248,111 to $12,744,336
Restitution:	N/A

The Court finds, and the United States Attorney's Office concurs, that defendant's theft of client funds and use of insider information to repay these monies is part of the same criminality. The Court added the $1,909,000 amount of the underlying loss to the fraud calculus in recognition of this fact. Therefore, the Court finds that defendant has a criminal history of I as contemplated by the Guidelines.

The sentence departs from the guideline range because the Court determines that the sentencing calculus set forth in the Presentence Investigation is driven by Counts 55, 56, and 57 — the money laundering counts — of the Indictment. In the Court's view, this is not the type of case contemplated by the United States Sentencing Commission when it established the guidelines for the offense of money laundering. Accordingly, the Court grants a 2 level downward departure.

The Court has given 75% credit for the 30 months served for the related state court convictions. Hence, the defendant shall receive credit for 23 months time served. The Court determines that a 75% credit for time served is warranted since the prior offense was intimately related to the federal crimes.

The Court finds that a fine of $150,000 is appropriate, since defendant does not have the ability to pay a fine above this amount.

TIMELINE OF IMPORTANT EVENTS

August 18, 1988

(1) Dorfman announces on CNN that insiders at Grand Met indicate that Grand Met interested in acquiring Pillsbury;

(2) Considine advises Appellant that he had received from an individual in London a $9 million order to purchase 250,000 shares of Pillsbury.

August 18, 1988—August 25, 1988

Between these dates, Appellant places *all* of his orders for options on Pillsbury stock.

August 26, 1988

Alleged conversation between Tinkham and Appellant wherein Appellant allegedly learned of Dorsey & Whitney's retention by some unknown client regarding the possible acquisition of Pillsbury.

September 9, 1988

Tinkham learns that Grand Met's possible acquisition may be by way of hostile takeover.

September 30, 1988

Grand Met sells hotel subsidiary, making possible its purchase of Pillsbury.

October 3, 1988

Grand Met board of directors authorizes tender offer for Pillsbury.

December 15, 1992

Appellant indicted in this case.

Supreme Court of the United States

No. 96-842

UNITED STATES, *PETITIONER*

v.

JAMES HERMAN O'HAGAN

ORDER ALLOWING CERTIORARI.
Filed January 17, 1997.

The petition for a writ of certiorari is granted. The brief of petitioner is to be filed with the Clerk and served upon opposing counsel on or before 3 p.m., Friday, February 28, 1997. The brief of respondent is to be filed with the Clerk and served upon opposing counsel on or before 3 p.m., Friday, March 28, 1997. A reply brief, if any, may be filed with the Clerk and served upon opposing counsel on or before 3 p.m., Wednesday, April 9, 1997. Rule 29.2 does not apply.

January 17, 1997

SUPREME COURT, U.S.
FILED
FEB 27 1997
CLERK

No. 96-842

In the Supreme Court of the United States

OCTOBER TERM, 1996

UNITED STATES OF AMERICA, PETITIONER

v.

JAMES HERMAN O'HAGAN

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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QUESTIONS PRESENTED

1. Whether respondent's trading in securities on material, nonpublic information that he misappropriated in breach of his fiduciary duties violated Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5.

2. Whether the Securities and Exchange Commission validly exercised its rulemaking authority under Section 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. 78n(e), in promulgating Rule 14e-3(a), 17 C.F.R. 240.14e-3(a), an insider trading rule relating to tender offers.

3. Whether respondent's trading in securities on material, nonpublic information that he misappropriated in breach of his fiduciary duties violated the mail fraud statute, 18 U.S.C. 1341, even if his conduct did not violate the securities laws.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statutory and regulatory provisions involved	2
Statement	2
Summary of argument	9
Argument:	
I. Trading in securites on misappropriated information violates Section 10(b) of the Exchange Act and Rule 10b-5	12
A. The misappropriation theory falls within Section 10(b)'s coverage of "deceptive devices" "in connection with" securities transactions	13
B. The misappropriation theory is consistent with the decisions of this Court	26
C. The misappropriation theory furthers important policies of the securities laws and has been accepted as valid in amendments to those laws	30
II. The SEC validly promulgated Rule 14e-3(a) pursuant to its rulemaking authority in Section 14(e) of the Exchange Act	36
A. The SEC's rulemaking power under Section 14(e) is not limited to regulating common law fraud or practices covered by Section 10(b)	36
B. Rule 14e-3(a) is a valid exercise of the SEC's rulemaking authority	41
C. Congressional action has validated Rule 14e-3(a)	44

Argument—Continued: Page

III. Respondent's misappropriation of confidential information to trade in securities violated the mail fraud statute 45

Conclusion 48

Appendix 1a

TABLE OF AUTHORITIES

Cases:

Affiliated Ute Citizens v. *United States*, 406 U.S. 128 (1972) 16

Batterton v. *Francis*, 432 U.S. 416 (1977) 36, 41

Blue Chip Stamps v. *Manor Drug Stores*, 421 U.S. 723 (1975) 25, 26

Cady, Roberts & Co., In re, 40 S.E.C. 907 (1961) 13, 14

Carpenter v. *United States*, 484 U.S. 19 (1987) 12, 16, 17, 20, 24, 33, 45, 46

Central Bank of Denver, N.A. v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) 10, 15, 20, 26, 29, 30

Chevron U.S.A. Inc. v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984) 36, 41

Chiarella v. *United States*, 445 U.S. 222 (1980) *passim*

Dirks v. *SEC*, 463 U.S. 646 (1983) 10, 13, 14, 24, 26, 27, 28, 29, 33

Dunn v. *Commodity Futures Trading Comm'n*, No. 95-1181 (Feb. 25, 1997) 23

Ernst & Ernst v. *Hochfelder*, 425 U.S. 185 (1976) 16, 31

Grin v. *Shine*, 187 U.S. 181 (1902) 17

Holmes v. *Securities Investor Protection Corp.*, 503 U.S. 258 (1992) 26

Moss v. *Morgan Stanley Inc.*, 719 F.2d 5 (2d Cir. 1983), cert. denied, 465 U.S. 1025 (1984) 34, 35

Pepper v. *Litton*, 308 U.S. 295 (1939) 18

Cases—Continued: Page

Post v. *United States*, 407 F.2d 319 (D.C. Cir. 1968), cert. denied, 393 U.S. 1092 (1969) 18

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SEC v. *Siegel*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,123 (S.D.N.Y. Feb. 13, 1987) 16

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Santa Fe Industries v. *Green*, 430 U.S. 462 (1977) 17, 18, 19

Schreiber v. *Burlington Northern, Inc.*, 472 U.S. 1 (1985) 38, 40, 41

Shushan v. *United States*, 117 F.2d 110 (5th Cir.), cert. denied, 313 U.S. 574 (1941) 20

Snepp v. *United States*, 444 U.S. 507 (1980) 45

Superintendent of Insurance v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971) 16, 17, 21

United States v. *Bryan*, 58 F.3d 933 (4th Cir. 1995) 23, 25

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United States v. *Naftalin*, 441 U.S. 768 (1979) 10, 22, 23, 25
United States v. *Newman*:
664 F.2d 12 (2d Cir. 1981) 16, 32, 35
722 F.2d 729 (2d Cir.), cert. denied, 464 U.S. 863 (1983) 16, 32
United States v. *Procter & Gamble Co.*, 47 F. Supp. 676 (D. Mass. 1942) 17, 19
United States v. *Rutherford*, 442 U.S. 544 (1979) ... 35
United States v. *Teicher*, 987 F.2d 112 (2d Cir.), cert. denied, 510 U.S. 976 (1993) 16

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Act of Dec. 22, 1970, Pub. L. No. 91-567, § 5, 84 Stat. 1497-1498 37
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§ 2, 102 Stat. 4677 ..... 2, 3a
§ 2(1), 102 Stat. 4677 ..... 33, 3a
Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 ..... 33, 44
Investment Advisers Act of 1940, 15 U.S.C. 80b-1 *et seq.* 18
Securities Act of 1933, 15 U.S.C. 77a *et seq.*:
§ 17(a)(1), 15 U.S.C. 77q(a)(1) 22
§ 17(a)(2), 15 U.S.C. 77q(a)(2) 20
Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq.*:
§ 2, 15 U.S.C. 78b 22, 30
§ 10(b), 15 U.S.C. 78j(b) ..... *passim*, 2a
§ 14(e), 15 U.S.C. 78n(e) ..... *passim*, 2a
§ 15(c)(2), 15 U.S.C. 78*o*(c)(2) 38, 39
§ 15(c)(2)(D), 15 U.S.C. 78*o*(c)(2)(D) 39
§ 20A(a), 15 U.S.C. 78t-1(a) 2, 34, 3a

Statutes and regulations—Continued: Page

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7 U.S.C. 2(ii) 23
18 U.S.C. 1341 ..... 2, 9, 45, 1a
18 U.S.C. 1956(a)(1)(B)(i) 2, 9
18 U.S.C. 1957 ..... 2, 9
17 C.F.R.:
Section 240.10b-5 (Rule 10b-5) ..... *passim*, 4a
Section 240.10b-5(a) 13
Section 240.10b-5(c) 13
Section 240.14e-3 (Rule 14e-3) 44, 45
Section 240.14e-3(a) (Rule 14e-3(a)) ..... *passim*, 4a
Section 240.15c2-1(1970) 39
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Section 240.15c2-4 (1970) 39
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H.R. Rep. No. 1711, 90th Cong., 2d Sess. (1968) 41
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Pt. 1 42
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Miscellaneous—Continued: Page

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In the Supreme Court of the United States

OCTOBER TERM, 1996

No. 96-842

UNITED STATES OF AMERICA, PETITIONER

v.

JAMES HERMAN O'HAGAN

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-39a) is reported at 92 F.3d 612. The order of the district court denying the motion to dismiss the indictment (Pet. App. 73a-74a) and the report and recommendation of the magistrate judge (Pet. App. 40a-72a) are unreported.

JURISDICTION

The judgment of the court of appeals was entered on August 2, 1996. A petition for rehearing was denied on November 13, 1996. Pet. App. 75a. The petition for a writ of certiorari was filed on November 26, 1996, and was granted on January 17, 1997 (J.A. 215). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The texts of 18 U.S.C. 1341, 15 U.S.C. 78j(b), 15 U.S.C. 78n(e), 15 U.S.C. 78t-1(a), 17 C.F.R. 240.10b-5, 17 C.F.R. 240.14e-3(a), and Section 2 of the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677, 15 U.S.C. 78u-1 note, are reprinted in an appendix to this brief.

STATEMENT

Following a jury trial in the United States District Court for the District of Minnesota, respondent was convicted on 20 counts of mail fraud, in violation of 18 U.S.C. 1341; 17 counts of securities fraud, in violation of Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78j(b), and Securities and Exchange Commission (SEC) Rule 10b-5, 17 C.F.R. 240.10b-5; 17 counts of fraudulent trading in connection with a tender offer, in violation of Section 14(e) of the Exchange Act, 15 U.S.C. 78n(e), and SEC Rule 14e-3(a), 17 C.F.R. 240.14e-3(a); one count of engaging in a monetary transaction in property derived from an unlawful activity, in violation of 18 U.S.C. 1957; and two counts of money laundering, in violation of 18 U.S.C. 1956(a)(1)(B)(i). He was sentenced to 41 months' imprisonment, to be followed by three years of supervised release, and was fined $150,000. The court of appeals reversed all the convictions. Pet. App. 1a-39a.

1. Respondent was a senior litigation partner in the law firm of Dorsey & Whitney (Dorsey), located in Minneapolis, Minnesota. He was also a sophisticated securities trader and had accounts at several brokerage firms. J.A. 62-63, 131, 138-139, 152; VIII Tr. 53.

In October 1986, respondent's client, Northrup King, transferred $1 million to the law firm's trust account as part of the preliminary settlement of a securities lawsuit.

IIa Tr. 67-74; III Tr. 14-17, 24-26. Although the settlement funds were to remain in a trust account until they were disbursed to the plaintiffs, respondent withdrew the entire $1 million through transfers to his personal bank accounts. IIa Tr. 80-81; III Tr. 18-20, 26-38; V Tr. 50-53. He used some of those funds to repay bank loans he had obtained to finance his securities trading. VII Tr. 5-9, 21.

On July 7, 1988, the trial judge presiding over the lawsuit against Northrup King ordered respondent to distribute the settlement funds. III Tr. 20, 37. To replace the funds stolen from the trust accounts, respondent used $185,000 that he had received from two other clients for the purpose of settling other cases. III Tr. 37-41, 84-89, 217-219. He also used funds from personal bank loans to pay claims under the settlement agreement. As of August 1988, however, he still needed more than $400,000 to pay the remaining claims. III Tr. 41-47, 52-53.

2. On July 19, 1988, Cravath, Swaine & Moore (Cravath), a law firm in New York, arranged to retain Dorsey as local counsel for Grand Metropolitan PLC (Grand Met), a company based in the United Kingdom. Dorsey was retained to represent Grand Met in connection with a potential tender offer for the common stock of Pillsbury Company, a company headquartered in Minnesota. J.A. 95-98, 123-125.

Grand Met and Cravath took extensive steps to protect the confidentiality of the information about the tender offer plan and limited the dissemination of information about the plan to as few people as possible. J.A. 101-103, 107-108, 134-136. Even within Grand Met, only seven or eight people knew the proposed offering price before the announcement of the tender offer. X Tr. 30-31. The efforts to keep the tender offer plans confidential were successful, for Pillsbury stock maintained a steady price before the tender offer was announced, and investors

discounted, as unfounded gossip, media stories suggesting a possible takeover of Pillsbury. J.A. 65-67, 71-72, 81-82, 104-106, 111.

Dorsey took similar steps to protect the confidentiality of the information about Grand Met's tender offer plans. Dorsey limited the dissemination of information to as few people as possible within the firm; the firm's file on the matter was opened under the name of Cravath, and the subject of the representation was described under the heading "general matters." J.A. 114-116. The firm also had a written policy requiring that the affairs of a client be kept strictly confidential. J.A. 26-31.

Thomas Tinkham, the chairman of the litigation department at Dorsey, was the partner assigned to head the Dorsey team of attorneys handling litigation matters related to Grand Met's acquisition of Pillsbury. Tinkham was scheduled to meet with partners from the law firm's corporate department on August 26, 1988, to discuss whether the firm should continue to represent Grand Met in its attempt to acquire a local company. A few days before that meeting, respondent stopped by Tinkham's office. Respondent told Tinkham that he understood that Tinkham was working on the Pillsbury takeover.[1] Respondent expressed an interest in working on the case, stating that he hated Pillsbury. Tinkham declined respondent's offer to work on the case, and he found that offer to be unusual, because respondent was more senior than Tinkham. Tinkham mentioned, however, that he was going to a

[1] The record does not indicate how respondent first learned of that closely guarded information. Respondent used his conversation with Tinkham, however, to confirm his knowledge of confidential firm and client information, and a properly instructed jury found that respondent had "gained access to, and then misappropriated material, nonpublic information, which was to be used only for Grand Met's purposes through a relationship of trust and confidence." J.A. 195.

meeting with partners from the corporate department to discuss whether the law firm should continue its representation against a local company. Tinkham asked respondent what position he should take at the meeting, and respondent expressed agreement with Tinkham that Dorsey should continue the representation. J.A. 125-133.[2]

3. Respondent began buying call options for Pillsbury stock on August 18, 1988.[3] By August 25, 1988, he had accumulated 500 Pillsbury September call options—each option giving him a right to purchase 100 shares of Pillsbury stock at $40 per share, on or before September 17, 1988. V Tr. 163-166; VI Tr. 18-20, 202-203; VIII Tr. 26-28; GX 34a. On August 29, 1988, respondent purchased 100 Pillsbury call options with an expiration date of October 22, 1988. The next day, he purchased 100 more Pillsbury October call options, as well as 50 Pillsbury call options with an expiration date of November 19, 1988. J.A. 55, 145. By the end of September 1988, he had amassed 2,500 Pillsbury call options, which at the time made him the largest individual investor in such options in the world. J.A. 85, 148, 157-160. He also purchased 5,000 shares of Pillsbury common stock on September 20, 1988, for just under $39 per share. J.A. 58, 154-156. He financed those

[2] At trial, Tinkham testified that he did not remember whether he specifically identified Grand Met as the client during his conversation with respondent. J.A. 132. Dorsey decided to continue its representation of Grand Met at the August 26 meeting, but withdrew its representation on September 9, 1988. J.A. 118.

[3] A call option gives the holder the right to buy "shares of a particular stock or stock index at a predetermined price before a preset deadline, in exchange for a premium. For buyers who think a stock will go up dramatically, call options permit a profit from a smaller investment than it would take to buy the stock." John Downes & Jordan Elliot Goodman, *Dictionary of Finance and Investment Terms* 70 (4th ed. 1995). See also J.A. 144-147.

purchases in part with $200,000 in proceeds from a bank loan on August 24, 1988, which was secured by a mortgage on his home. V Tr. 168, 170-171, 216; VI Tr. 48-49, 121-122, 173-175, 204, 206-208; J.A. 161-162.

On October 4, 1988, Grand Met publicly announced its tender offer for Pillsbury stock. Following the announcement, the price of Pillsbury stock rose from $39 per share to nearly $60 per share. J.A. 100. Respondent then sold all his Pillsbury call options. J.A. 55, 140-141.[4] He also sold the 5,000 shares of Pillsbury common stock that he had acquired. J.A. 56. Confirmations of his trades in Pillsbury securities were mailed to him by his brokerage firms. J.A. 140, 141, 149.

Respondent made a total profit of more than $4.3 million on his trades of Pillsbury securities. J.A. 56. 162. He used those profits to replenish the funds he had stolen from the firm's trust accounts. III Tr. 47-56, 203-209; V Tr. 186-188.

4. Respondent was convicted on 57 counts arising out of his trading in Pillsbury securities, including 20 counts of mail fraud, 17 counts of securities fraud in violation of Section 10(b) of the Exchange Act and Rule 10b-5, and 17 counts of fraudulent trading in connection with a tender offer, in violation of Section 14(e) of the Exchange Act and Rule 14e-3(a). The court of appeals reversed all the convictions. Pet. App. 1a-39a.

a. The court of appeals noted that respondent's convictions under Section 10(b) and Rule 10b-5 were based solely on the "misappropriation theory" of securities fraud. The misappropriation theory, the court explained, "has been held to impose § 10(b) and Rule 10b-5 liability for fraud on an individual who (1) misappropriates material nonpublic

[4] Because the price of Pillsbury stock had not reached $40 per share by September 17, the September call options had expired worthless. J.A. 144-145, 146, 160.

information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock." Pet. App. 9a (internal quotation marks omitted). Specifically, the court noted, respondent was alleged to have "breached a fiduciary duty to Dorsey & Whitney and Grand Met when, through his employment at Dorsey & Whitney, he obtained confidential, material, and nonpublic information concerning Grand Met's interest in acquiring Pillsbury, and subsequently used that information as a basis for trading in Pillsbury securities." *Id.* at 10a.

The court of appeals held that the misappropriation theory is not a valid basis for liability under Section 10(b) and Rule 10b-5. Pet. App. 11a-24a. It concluded that the misappropriation theory does not meet Section 10(b)'s requirement of a "deceptive device," in that it "permits the imposition of § 10(b) liability based upon the mere breach of a fiduciary duty without a particularized showing of misrepresentation or nondisclosure," *id.* at 12a-13a, and "the mere breach of a fiduciary obligation, without misrepresentation or nondisclosure, is not deception within the meaning of § 10(b)," *id.* at 13a.

The court of appeals also concluded that the misappropriation theory does not meet Section 10(b)'s requirement that the fraud be employed "in connection with the purchase or sale of any security." According to the court, the theory "permits liability for a breach of a duty owed to individuals who are unconnected to and perhaps uninterested in a securities transaction, thus rendering meaningless the 'in connection with . . .' statutory language." Pet. App. 13a. Since, the court stated, "the principal concern of section 10(b) is the protection of purchasers and sellers of securities," it concluded that "only a breach of a

duty to parties to the securities transaction or, at the most, to other market participants such as investors, will be sufficient to give rise to § 10(b) liability." *Id.* at 13a-14a.

b. The court of appeals also reversed respondent's convictions under Section 14(e) and Rule 14e-3(a). It held that Rule 14e-3(a), which prohibits certain persons from trading while in possession of material, nonpublic information relating to a tender offer obtained from the bidder or the target, exceeds the SEC's rulemaking authority under Section 14(e) because the Rule applies whether or not such trading breaches a fiduciary duty. Pet. App. 24a-36a.

The court acknowledged that Section 14(e) authorizes the SEC to "define" and "prescribe means reasonably designed to prevent" "acts and practices" which are "fraudulent" in connection with tender offers. Pet. App. 28a. It concluded, however, that, while "the enabling provision of § 14(e) permits the SEC to identify and regulate those 'acts and practices' which fall within the § 14(e) legal definition of 'fraudulent,'" it "does not grant the SEC a license to redefine the term." *Id.* at 28a-29a. It also concluded that the SEC's additional authority under the statute to "prescribe means reasonably designed to prevent" fraudulent acts was of no significance; "this provision means simply that the SEC has broad regulatory powers in the field of tender offers, but the statutory terms have a fixed meaning which the SEC cannot alter by way of an administrative rule." *Id.* at 35a.

As to the meaning of "fraudulent" in Section 14(e), the court found "no indication that the term was to have a meaning different from its common legal definition." Pet. App. 29a. The court concluded "that 'fraudulent' under § 14(e) must be interpreted to require the breach of a fiduciary obligation or similar trust relationship." *Id.* at 32a. The court thus held that "the SEC exceeded its rulemaking authority under § 14(e) when it promulgated

Rule 14e-3(a) without including a requirement of a breach of a fiduciary obligation." *Id.* at 36a.

c. Based on its reversal of the securities fraud convictions, the court of appeals also reversed respondent's mail fraud convictions under 18 U.S.C. 1341. Pet. App. 36a-37a. It noted that "[t]he mere fact that [respondent's] securities convictions have been reversed does not as a matter of law require that the mail fraud convictions likewise be reversed." *Id.* at 36a. In the court's view, however, "the indictment was structured in such a manner as to premise the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud." *Id.* at 37a. "Because [respondent's] conduct did not constitute securities fraud," the court reasoned that "there was no fraud upon which to base the mail fraud charges." *Ibid.*[5]

d. Judge Fagg dissented. He believed that both the misappropriation theory of liability under Section 10(b) and SEC Rule 14e-3(a) are valid. He therefore would have affirmed respondent's convictions on all 57 counts. Pet. App. 38a-39a.

SUMMARY OF ARGUMENT

I. The misappropriation of material, nonpublic information for securities trading violates Section 10(b) and Rule 10b-5. Under the misappropriation theory, it is a "deceptive device" "in connection with the purchase or sale of any security" for a person to misappropriate confidential information, in breach of a fiduciary or similar duty of trust and confidence, by using that information in securities trading. The theory satisfies Section 10(b)'s

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[5] The court also overturned respondent's conviction for engaging in a monetary transaction in property derived from an unlawful activity under 18 U.S.C. 1957, and his convictions for money laundering under 18 U.S.C. 1956(a)(1)(B)(i), because "they were predicated on the securities fraud or mail fraud counts." Pet. App. 37a.

requirement of "decepti[on]," because the misappropriator, in order to convert the information to his own benefit by trading on it, deceives the information's legitimate possessor into believing that he is acting as a faithful agent. The theory also satisfies Section 10(b)'s requirement that the deception be "in connection with" a securities transaction, because the information is converted for the sole purpose of, and derives its personal value to the misappropriator only from its utility in, securities trading. Indeed, the act of misappropriation is completed by the exploitation of the converted information in the securities market.

The deception in a misappropriation case is practiced on the source of the information, rather than on the investor with whom the misappropriator trades. That fact, however, does not make Section 10(b) inapplicable. Section 10(b) authorizes the SEC to promulgate regulations "as necessary or appropriate in the public interest *or* for the protection of investors" (emphasis added). Even when deception is not practiced directly on the person on the other side of a securities trade, the SEC has the authority to prohibit deception that would have a deleterious effect on the integrity of the securities markets and investor confidence in those markets. The federal securities laws are not limited to the protection of investors. See *United States* v. *Naftalin*, 441 U.S. 768 (1979).

The misappropriation theory is consistent with this Court's decisions in *Chiarella* v. *United States*, 445 U.S. 222 (1980), *Dirks* v. *SEC*, 463 U.S. 646 (1983), and *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). It also promotes the underlying purposes of the securities laws. The proscription of misappropriation strengthens the confidence of investors that the securities markets are not characterized by the misuse of inside information based on illegal acts, and it

protects legitimate investment in information gathering and analysis. Finally, the theory has been validated by amendments to the securities laws.

II. Rule 14e-3(a) is a valid exercise of the SEC's rulemaking authority under Section 14(e). Section 14(e) forbids fraudulent practices in the tender offer setting and authorizes the SEC to promulgate rules, for purposes of that subsection, that "define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative." Rule 14e-3(a) prohibits trading by a person in possession of material, nonpublic information about a tender offer that he knows or has reason to know comes from the bidder, the target, or an insider or adviser of either, without requiring a showing that trading on such undisclosed information violates any fiduciary duty.

Rule 14e-3(a) is within the SEC's broad authority under Section 14(e) to proscribe deleterious practices in connection with tender offers. First, the SEC may use its "defining" power under Section 14(e) to identify fraudulent practices in the tender offer setting beyond the proscriptions of common law fraud and other provisions of the securities laws. In prohibiting trading in the tender offer setting on undisclosed information, even absent a fiduciary (or similar) duty to speak, the SEC validly exercised its power to "define" such acts as are fraudulent or deceptive. The "defining" power would be a virtual nullity were the SEC not permitted to go beyond common law fraud (which is separately prohibited in the first sentence of Section 14(e)). Second, the SEC may also "prescribe means reasonably designed to prevent[] such acts and practices as are fraudulent, deceptive, or manipulative" in connection with tender offers. That power plainly authorizes prophylactic rules. Thus, the SEC may "prevent" difficult-to-detect fraudulent practices that are likely to occur in

connection with tender offers by establishing a flat ban on a class of trading on undisclosed material information.

III. The mail fraud statute is applicable to fraudulent schemes to misappropriate confidential information for securities trading. In *Carpenter* v. *United States*, 484 U.S. 19 (1987), this Court held that an employee's deceptive misuse of confidential business information for personal gain in securities trading violated the mail fraud statute. *Carpenter* makes clear that the mail fraud statute prohibits that form of fraud whether or not the same acts violate the federal securities laws. The same conclusion applies here to respondent's conversion of information that belonged to his law firm and its client for the purpose of his personal profit in securities trading.

ARGUMENT

I. TRADING IN SECURITIES ON MISAPPROPRIATED INFORMATION VIOLATES SECTION 10(b) OF THE EXCHANGE ACT AND RULE 10b-5

Under the misappropriation theory of insider trading liability, it is a "deceptive device" "in connection with the purchase or sale of any security" when a person, in breach of a fiduciary or similar duty of trust and confidence, converts his principal's information by using that information for his personal benefit in securities trading. That theory of liability is consistent with the texts of Section 10(b) and Rule 10b-5.[6] It also accords with the decisions of this

[6] Section 10(b) of the Exchange Act makes it unlawful for "any person"

> To use or employ, in connection with the purchase or sale of any security[,] * * * any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. 78j(b). The SEC's Rule 10b-5 implements that statutory proscription by providing that it is unlawful for any person "[t]o employ any device, scheme, or artifice to defraud * * * or [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person[] in connection with the purchase or sale of any security." 17 C.F.R. 240.10b-5(a) and (c).

Court construing those provisions. Finally, the theory promotes the underlying purposes of those provisions, and it has been validated by legislation recently enacted by Congress. The court of appeals therefore erred in reversing respondent's convictions under the misappropriation theory.

A. The Misappropriation Theory Falls Within Section 10(b)'s Coverage Of "Deceptive Devices" "In Connection With" Securities Transactions

There are two theories of insider trading liability under Section 10(b). Under the "classical theory," corporate officers, directors, and other insiders violate Section 10(b) and Rule 10b-5 when they trade in their own corporation's securities on material, nonpublic information. See *Dirks* v. *SEC*, 463 U.S. 646, 653 (1983); *Chiarella* v. *United States*, 445 U.S. 222, 226-227 (1980); *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969); *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961). Trading on undisclosed material information by corporate insiders is a "deceptive device" because the insider has a fiduciary duty to the corporation's shareholders not to take unfair advantage of them for personal gain. See *Chiarella*, 445 U.S. at 228-229. Accordingly, an insider who engages in a transaction in his own corporation's stock must disclose material, non-

public information before trading; otherwise, he must abstain from trading. See *id.* at 227-228.[7]

Under the misappropriation theory of insider trading, a person commits fraud on the source of information for securities trading when he uses confidential information for his trading in a breach of a fiduciary or similar duty owed to the source. The misappropriation theory protects the integrity of the securities markets against abuses by "outsiders" to a corporation who have access to confidential information that will affect that corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders. For example, an employee of an investment adviser may learn that his firm intends to recommend that clients buy stock in a certain corporation; a deceitful employee may then, in advance of the recommendation, improperly trade for his personal benefit to take advantage of an anticipated rise in price. Or (as in this case) an attorney may learn, in the course of his employment, that a client of his firm plans to acquire a target company; a dishonest attorney may then improperly exploit that information by purchasing securities in the target company, before the announcement of the

[7] The classical theory reaches transactions with existing shareholders as well as persons who become shareholders by purchasing from the insider. *Chiarella*, 445 U.S. at 227 n.8; *Cady, Roberts*, 40 S.E.C. at 914 n.23. It also applies to trading by "temporary insiders," such as attorneys, underwriters, accountants, and consultants who become fiduciaries of the shareholders when, because of their "special confidential relationship" with the business, they receive access to confidential corporate information to be used solely for corporate purposes. *Dirks*, 463 U.S. at 655 n.14. And a "tippee" who receives confidential information about a corporation from an insider or other fiduciary of the firm, knowing or having reason to know that the tipper has breached his fiduciary duty by disclosing the information for his personal benefit, inherits the tipper's fiduciary duty and thereby assumes the duty to disclose or abstain. *Id.* at 660, 662.

acquisition causes the target's stock price to soar. In such cases, a trusted agent defrauds the legitimate owner of the right of exclusive use of its information and reaps illicit profits by employing the information in securities trading.

In this case, respondent unquestionably had a fiduciary obligation to Grand Met and Dorsey not to abuse his position by converting information about Grand Met's tender offer plans to his own benefit. By deceiving his firm and its client into believing that he remained a loyal partner and agent, while in fact pursuing personal gain by trading on their information, respondent was able to earn enormous and virtually risk-free profits in the securities markets. Such trading on converted confidential information is a form of fraud that poses a serious threat to investor confidence in honest securities markets. It therefore implicates Section 10(b)'s protections against fraud in connection with securities trading.

The court of appeals concluded, however, that the misappropriation theory could not be squared with the language of Section 10(b). The court believed that the theory does not satisfy either the statute's requirement of "deceptiti[on]" or its requirement that the deception be "in connection with" the purchase or sale of a security. Pet. App. 11a-12a, 13a-15a. The court of appeals correctly noted that, "[w]ith respect * * * to * * * the scope of conduct prohibited by § 10(b), the text of the statute controls [this Court's] decision." *Id.* at 7a (quoting *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (1994)). But contrary to the court of appeals' conclusion, the misappropriation theory is firmly grounded in the text of Section 10(b).[8]

[8] This Court reserved judgment on the validity of the misappropriation theory in *Chiarella*, 445 U.S. at 236, and was evenly divided over

1. *Misappropriation is a "deceptive device or contrivance."* Section 10(b) makes it unlawful for a person to use "*any* manipulative or deceptive device or contrivance" in connection with the purchase or sale of a security (emphasis added). Section 10(b) does not require that the deception take a particular form; it prohibits "*all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception." *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 11 n.7 (1971); see also *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972). Section 10(b) "must be read flexibly, not technically and restrictively," *Bankers Life*, 404 U.S. at 12, for it was framed as a "catch-all" provision to reach all "cunning devices" related to securities transactions. See *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 202 (1976) (quoting *Stock Exchange Regulation: Hearing on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate*

its validity in *Carpenter* v. *United States*, 484 U.S. 19, 24 (1987). Both before and since *Carpenter*, the misappropriation theory has been a cornerstone in the SEC's efforts to combat the deceptive misuse of confidential information in the nation's securities markets. The theory has been used in the past 15 years in scores of civil and criminal cases, including some of the most significant securities fraud cases of that period. See, *e.g.*, *SEC* v. *Drexel Burnham Lambert, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,474 (S.D.N.Y. June 20, 1989) (consent judgment); *SEC* v. *Siegel*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,123 (S.D.N.Y. Feb. 13, 1987) (consent judgment); *SEC* v. *Boesky*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,991 (S.D.N.Y. Nov. 14, 1986) (consent judgment); *SEC* v. *Levine*, No. 86 Civ. 3726 (S.D.N.Y. May 12, 1986) (consent judgment). It has also formed the basis of many criminal prosecutions. See, *e.g.*, *United States* v. *Newman*, 664 F.2d 12 (1981), aff'd after remand, 722 F.2d 729 (2d Cir.) (Table), cert. denied, 464 U.S. 863 (1983); *United States* v. *Teicher*, 987 F.2d 112 (2d Cir.), cert. denied, 510 U.S. 976 (1993).

and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934) (statement of Thomas Corcoran)). And while "what [Section 10(b)] catches must be fraud," *Chiarella*, 445 U.S. at 235, misappropriation is a classic form of fraud.

Misappropriation fits well within the language of Section 10(b). When an agent uses his agency relationship to convert confidential information entrusted to him by his principal, he employs a "deceptive device." Such an unfaithful agent maintains a pretense of loyalty to the principal while secretly converting the principal's information for personal gain. Such conversion is a well recognized species of fraud. As the Court made clear in *Carpenter* v. *United States*, 484 U.S. 19 (1987), which involved the mail fraud statute's proscription of any "scheme or artifice to defraud," fraud includes the embezzlement of confidential information, *i.e.*, "the fraudulent appropriation to one's own use of the [information] entrusted to one's care by another." *Id.* at 27 (quoting *Grin* v. *Shine*, 187 U.S. 181, 189 (1902)). In *Carpenter*, the Court held that an employee's undertaking not to reveal his employer's confidential information "became a sham" when the employee violated his duty by providing the information to co-conspirators in a scheme to obtain trading profits. *Ibid.* See also *United States* v. *Procter & Gamble Co.*, 47 F. Supp. 676, 678 (D. Mass. 1942); Restatement (Second) of Agency § 395 (1958). Since "it is impossible for a person to embezzle the [property] of another without committing a fraud upon him," *Grin* v. *Shine*, 187 U.S. at 189, misappropriation may be considered, as it was in *Carpenter*, a "'garden variety' type of fraud," *Bankers Life*, 404 U.S. at 11 n.7.[9]

[9] The court of appeals rejected reliance on *Carpenter*'s interpretation of "scheme to defraud" in the mail fraud statute because it believed that *Santa Fe Industries* v. *Green*, 430 U.S. 462 (1977), "made

The court of appeals erred in concluding that the misappropriation theory permits liability on the mere breach of a fiduciary duty, without deception, in conflict with *Santa Fe Industries* v. *Green*, 430 U.S. 462 (1977). Pet. App. 11a-12a. *Santa Fe* involved a "short-form" merger, effected by majority shareholders, that was alleged to be substantively unfair to minority shareholders. The Court assumed, for the purpose of deciding the case, that the merger terms were grossly undervalued, in breach of a state-law fiduciary duty to minority shareholders. The Court concluded, however, that there was no "deception" within the meaning of Section 10(b) because the minority shareholders, presented with the choice of accepting the merger terms or seeking an appraisal in state court, "were furnished with all relevant information on which to base their decision," 430 U.S. at 474, including an appraisal that called into question the substantive fairness of the merger terms, *id.* at 468-469. *Santa Fe* held that a mere

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clear that in construing § 10(b) resort could not be had to analogous federal statutes." Pet. App. 20a. *Santa Fe*'s caution against importing into the securities laws all concepts of fraud appearing in other federal statutes (430 U.S. at 471 & n.11) does not undermine the relevance of *Carpenter* here. In *Santa Fe*, the Court noted that one of the cases consulted by the court of appeals for an analogy, *Pepper* v. *Litton*, 308 U.S. 295 (1939), involved disallowance of a bankruptcy claim on equitable grounds, while another case, *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), had construed the Investment Advisers Act of 1940, which was intended to establish federal fiduciary standards for investment advisers. 430 U.S. at 471 n.11. The Court did not suggest that traditional concepts of fraud and deception, as incorporated into federal criminal statutes, could not be consulted for guidance on the reach of Section 10(b). The mail fraud statute is a particularly apt source of guidance here, because it (like Section 10(b)) has long been held to require deception, not merely the breach of a fiduciary duty. See *Post* v. *United States*, 407 F.2d 319, 329 (D.C. Cir. 1968), cert. denied, 393 U.S. 1092 (1969).

breach of fiduciary duty, without deception or manipulation, does not violate Section 10(b), see *id.* at 475-476; it did not hold that a breach of fiduciary duty that *does* involve deception is outside the reach of Section 10(b).

The misappropriation theory, by definition, requires deception. Conversion of confidential information by its very nature involves deception, for the scheme's success depends on the agent's lulling the principal into believing that the agent is trustworthy. "The actual deception that is practised is in the continued representation of the employee to the employer that he is honest and loyal to the employer's interests." *Procter & Gamble*, 47 F. Supp. at 678; see also *United States* v. *Buckner*, 108 F.2d 921, 926 (2d Cir.) (affirming mail fraud conviction on theory that "[u]sing a fiduciary position * * * to obtain secret profits based upon inside information is not only a breach of trust, but an active fraud"), cert. denied, 309 U.S. 669 (1940). Accordingly, *Santa Fe*, which involved a transaction in which all material facts were fully disclosed, does not create doubt that misappropriation in breach of a fiduciary or similar duty is "deceptive."

The court of appeals also suggested that the misappropriation theory falls outside Section 10(b) because it does not require an express misstatement of fact or nondisclosure in breach of a duty to speak. Section 10(b)'s coverage of "deceptive device[s]," however, reaches deceptive *acts* as well as statements and omissions, and such acts have long been understood to constitute fraud.[10] See

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[10] A legal dictionary in use when Section 10(b) was drafted shows that the concept of deception was not viewed at that time as limited to express statements and omissions, but included misleading conduct as well. See *Black's Law Dictionary* 529 (3d ed. 1933) ("DECEPTION. The act of deceiving; intentional misleading by falsehood spoken *or acted*.") (emphasis added). Contemporary definitions are in accord. See *The Random House Unabridged Dictionary of the English*

Shushan v. *United States*, 117 F.2d 110, 115 (5th Cir.) ("A scheme to get money unfairly by obtaining and then betraying the confidence of another * * * would be a scheme to defraud though no lies were told."), cert. denied, 313 U.S. 574 (1941). Section 10(b) therefore readily applies to one who misappropriates information with which he is entrusted in violation of his "implicit representation that he would not convert the thing to his own use." Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 Hofstra L. Rev. 101, 119 (1984); see *Carpenter*, 484 U.S. at 27-28 (employee's promise not to misuse confidential information "became a sham" when he did so, "all the while pretending to perform his duty of safeguarding it").[11]

In any event, misappropriation will often involve overt lies. Here, for example, respondent, in his conversation with Thomas Tinkham, feigned an interest in working on

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Language 516 (2d ed. 1987) ("deceive * * * 1. to mislead by a false *appearance* or statement") (emphasis added). Section 10(b)'s prohibition of any "deceptive device or contrivance" thus implies coverage of the full range of schemes to deceive, not just statements or omissions. By contrast, narrower language in Section 17(a)(2) of the Securities Act of 1933, 15 U.S.C. 77q(a)(2), reaches only "any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."

[11] The court of appeals mistakenly relied on *Central Bank*'s statement that Section 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." 511 U.S. at 177. The Court in *Central Bank* was not addressing whether a "deceptive device" might include deceptive acts other than misrepresentation or lack of disclosure. Rather, the Court was examining only whether there is a private right of action against a person who aids or abets a violation of Section 10(b) but does not himself engage in "deception." See *id.* at 174, 177-178; see also p. 29, *infra* (discussing *Central Bank*).

litigation involving the Pillsbury takeover—a pretense designed to elicit confirmation of the planned takeover. See pp. 4-5, *supra*. The deception in a case of misappropriation of confidential information also involves a breach of a duty to disclose, for an agent who wishes to use his principal's confidential information for his own benefit must obtain the principal's consent and disclose all relevant facts. See Restatement (Second) of Agency § 395 & cmt. c (1958). And, as one commentator has noted, "[f]ew if any breaches of loyalty are done without some effort to avoid detection." Donald C. Langevoort, *Fraud and Deception by Securities Professionals*, 61 Tex. L. Rev. 1247, 1266 (1983). Misappropriation of confidential information therefore satisfies Section 10(b)'s requirement of deception.

2. *The misappropriation theory meets the "in connection with" requirement.* The misappropriation of confidential information for securities trading also satisfies Section 10(b)'s requirement that the deception be "in connection with" the purchase or sale of a security. Here, the misappropriated information had personal value to respondent only because of its utility in securities trading; indeed, his misappropriation was not complete until he traded on the information. Respondent's fraud consisted of the deceptive use of the information about Grand Met's plans *for the purpose* of respondent's trading; the trading was an essential element of respondent's "deceptive device." The misappropriation theory thus depends on an inherent connection between the deceptive conduct and the purchase or sale of a security. Cf. *Bankers Life*, 404 U.S. at 12-13 (fraud was "in connection with" sale of securities when corporate insider induced corporation to sell Treasury bonds so that insider could misappropriate the proceeds of the sale).

The fact that respondent practiced his deception on the source of his information rather than on the investors who sold the securities does not defeat the application of Section 10(b). The statute does not proscribe deception "on a purchaser or seller of a security"; it applies to any deceptive device "in connection with the purchase or sale of any security." Moreover, Section 10(b) authorizes the SEC to prohibit deceptive devices "as necessary or appropriate in the public interest *or* for the protection of investors" (emphasis added). Consistent with the breadth of the statutory language, Section 10(b)'s purposes extend beyond the prevention of fraud perpetrated directly on purchasers and sellers. The SEC thus has the authority to prohibit deceptive acts that, it concludes, would have a deleterious effect on the integrity of the securities markets and on investor confidence in those markets, even if the deception is not practiced directly on the person on the other side of a securities trade. See also 15 U.S.C. 78b (purpose of Exchange Act is "to insure the maintenance of fair and honest markets").

In *United States* v. *Naftalin*, 441 U.S. 768 (1979), the court rejected the contention that Section 17(a)(1) of the Securities Act of 1933, 15 U.S.C. 77q(a)(1)—which prohibits any device, scheme, or artifice to defraud "in the offer or sale of any securities"—requires that the deception be practiced on the person on the other side of a securities trade. The Court found no merit in the view that Congress's concern in enacting the Securities Act of 1933 "was limited to investors," and noted that "the welfare of investors and financial intermediaries are inextricably linked—frauds perpetrated upon either business or investors can redound to the detriment of the other and to the economy as a whole." See 441 U.S. at 775-776. *Naftalin* involved the prosecution of an investor who directed his broker to sell certain shares, falsely representing to the broker that he owned the shares; in fact, the investor was "selling short" and did not have the means to make covering purchases when the market prices of the shares that he "sold" rose. The brokers who were deceived suffered losses, but the investors who actually purchased the shares did not. Naftalin argued that the 1933 Act's prohibition against fraud "in" the offer or sale of securities was narrower than Section 10(b)'s proscription against deception "in connection with" a purchase or sale, and so did not reach deception of brokers. While expressing doubt that the phrases had a different scope, the Court, even on the assumption that "in" was narrower than "in connection with,"[12] rejected the argument that the 1933 Act was limited to frauds on investors. See *id.* at 773 & n.4. If fraud "in" a securities transaction does not require fraud on an investor, then deception "in connection with" a securities transaction also does not.

Nor is the misappropriation theory vulnerable on the view that it "transforms section 10(b) from a rule intended to govern and protect relations among market participants who are owed duties under the securities laws into a federal common law governing and protecting any and all trust relationships." *United States* v. *Bryan*, 58 F.3d 933, 950 (4th Cir. 1995). The theory applies only when the breach of duty involves misappropriation of information, and only when the information is used as the basis of a

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[12] Compare *Dunn* v. *Commodity Futures Trading Commission*, No. 95-1181 (Feb. 25, 1997), slip op. 5 (in construing the phrase "transactions *in* foreign currency" in 7 U.S.C. 2(ii) (emphasis added), the Court noted that the word "in" "is usually thought to be 'synonymous with [the] expressions "in regard to," "respecting," [and] "with respect to"'").

trade in securities.[13] Furthermore, the classical theory of insider trading itself is premised on fiduciary (and similar) relationships arising under common law. See *Chiarella*, 445 U.S. at 227-228 (describing "common law" disclosure requirements based on fiduciary duties); *Dirks*, 463 U.S. at 655 & n.14 (applying disclose-or-abstain rule to advisers, such as attorneys, who "may become fiduciaries of the shareholders"). The misappropriation theory likewise describes consequences for fiduciaries (and those in similar positions of trust and confidence) who engage in deceptive breaches in connection with securities transactions.

The task of identifying those relationships in which the improper use of confidential information for personal gain constitutes a deceptive practice under Section 10(b) is not unduly difficult, and it parallels the similar inquiry under the mail fraud statute. See *Carpenter*, *supra*. Respondent's deception of his law firm and its client, for example, involved relationships that "[t]he common law has recognized * * * are inherently fiduciary." *United States* v. *Chestman*, 947 F.2d 551, 568 (2d Cir. 1991) (opinion of Meskill, J.) (en banc) ("Counted among these hornbook fiduciary relations are those existing between attorney and client, * * * [and] principal and agent."), cert. denied, 503 U.S. 1004 (1992).

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[13] The misappropriation theory would not, in contrast, apply to a case in which a person defrauded a bank into giving him a loan or embezzled cash from another, and then used the proceeds of the misdeed to purchase securities. In those cases, the proceeds would have value to the malefactor apart from their use in a securities transaction, and the fraud would be complete as soon as the money was obtained. Material, nonpublic information affecting security prices, however, is valuable to a misappropriator because it enables him to make profits in the securities market. Indeed, the fraud is not consummated until the information is used in trading.

The court of appeals objected to the misappropriation theory on the ground that it protects from fraud entities other than market participants. See Pet. App. 15a-16a; accord *Bryan*, 58 F.3d at 946-949. Respondent, however, misappropriated information about an upcoming takeover from the bidder and a law firm retained to represent it. The proper functioning of the securities markets requires that the bidder (who is poised to become a "market participant") be protected against the fraudulent use of confidential business plans. The same protection is also needed for the law firms and investment advisers who represent and counsel bidders in transactions. Those advisers are properly viewed as "temporary insiders," see note 7, *supra*, and they necessarily learn the confidential business plans of market participants. It would be pointless to protect the market participants themselves against fraud in connection with securities trading while leaving unprotected the confidential advisers who are indispensable to the market participants' actions.

Nothing in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), suggests that the direct protection of investors against fraud is the exclusive concern of Section 10(b). There, the Court limited the class of persons who may bring an implied private right of action under Section 10(b) and Rule 10b-5 to those who have actually purchased or sold securities. The Court recognized that purchaser-seller standing rule largely because of "policy considerations" (*id.* at 737) involving the dangers of litigation by investors who did not make an actual purchase or sale but who might later claim that they would have done so in the absence of alleged deceptive conduct by others. While the Court did note that Section 10(b)'s wording "is directed toward injury suffered 'in connection with the purchase or sale' of securities," *id.* at 733, that observation was intended to distinguish an actual "sale" from a general

selling program or an offer to sell. See *id.* at 733 n.5. The Court did not purport to catalogue the types of injuries that might be suffered "in connection with [a] purchase or sale." And in *Naftalin*, the Court made clear that the purchaser-seller standing rule of *Blue Chip Stamps* is "inapplicable" to a criminal prosecution. 441 U.S. at 774 n.6. See also *Blue Chip Stamps*, 421 U.S. at 751 n.14 (purchaser-seller rule "imposes no limitation on the standing of the SEC to bring actions for injunctive relief"); *Chiarella*, 445 U.S. at 238 (Stevens, J., concurring); *Holmes* v. *Securities Investor Protection Corp.*, 503 U.S. 258, 281, 284, 285 (1992) (O'Connor, J., concurring in part and concurring in the judgment); *id.* at 289-290 (Scalia, J., concurring in the judgment).

B. The Misappropriation Theory Is Consistent With The Decisions Of This Court

Although the text of Section 10(b) readily supports the misappropriation theory, the court of appeals read this Court's decisions in *Chiarella* v. *United States*, 445 U.S. 222 (1980), *Dirks* v. *SEC*, 463 U.S. 646 (1983), and *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), to hold that "only a breach of a duty to parties to the securities transaction or, at the most, to other market participants such as investors, will be sufficient to" violate Section 10(b). Pet. App. 13a-14a. None of those cases, however, stands for that proposition.

Chiarella involved securities trades by a printer employed at a shop that had been engaged to print announcements for companies planning takeover bids. After deducing the identity of the target companies from the materials furnished by the acquiring companies, Chiarella bought shares of the targets before the bids were announced, expecting (correctly) that the share prices would rise upon announcement. Even though Chiarella had

gained access to, and traded on, information not available to the market, the Court concluded that he had not violated Section 10(b) by trading without disclosing that information, because he had not been shown to have breached any duty to disclose to his trading partners (the target companies' shareholders). 445 U.S. at 232-233. The Court explained that there is no "general duty between all participants in market transactions to forgo actions based on material, nonpublic information," and that a duty to disclose, or abstain from trading on, material, nonpublic information must arise "from a specific relationship between two parties." *Id.* at 233.

The Court did not hold in *Chiarella* that the *only* relationship that gives rise to liability when trading on undisclosed information is the relationship between a corporation's insiders and shareholders. The government argued in this Court that Chiarella's misappropriation of information from his employer for securities trading, in violation of a duty to the acquiring companies, constituted fraud in connection with the purchase or sale of a security under Section 10(b). 445 U.S. at 235-236. The Court declined to reach that theory, because the jury had not been instructed on it. *Id.* at 236-237. Four Justices, however, voiced support for that theory, see *id.* at 239 (Brennan, J., concurring in the judgment); *id.* at 240-243 (Burger, CJ., dissenting); *id.* at 245 (Blackmun, J., joined by Marshall, J., dissenting), and a fifth Justice stated that the "Court correctly does not address" the issue, but "wisely leaves the resolution of this issue for another day," *id.* at 238 (Stevens, J., concurring). *Chiarella* thus left open the question presented in this case.

Dirks involved an investment analyst who received information from Secrist, a former insider of a corporation with which Dirks had no connection, indicating that the corporation had engaged in massive fraud. Secrist urged

Dirks to investigate the fraud; after doing so and verifying the information, Dirks recommended to his clients that they sell their holdings in that company. Viewing Dirks as a "tippee" of Secrist, the SEC concluded that Dirks had inherited, and had violated, Secrist's fiduciary duty to the shareholders to disclose or abstain from trading on nonpublic information. 463 U.S. at 649-651.

This Court disagreed, rejecting in particular the argument that Dirks had assumed an insider's duty to disclose or abstain *solely* because he had received nonpublic information. 463 U.S. at 655-658. That argument, the Court concluded, was essentially the same as the one rejected in *Chiarella*, *i.e.*, that all persons with any advantage based on nonpublic information must disclose the information or abstain from trading. *Id.* at 656-657. The Court held, rather, that, because a tippee's duty can be no greater than that of the insider, the tippee assumes a duty to disclose or abstain "only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach." *Id* at 660. Because there had been no showing that Secrist had violated any duty by disclosing the nonpublic information about his former employer to Dirks, there was also no violation by Dirks. *Id.* at 665-667.

Dirks did not suggest that a person who gains an informational advantage unlawfully, through misappropriation in breach of a fiduciary duty, may freely trade on that advantage. Indeed, the Court noted in *Dirks* that "[t]here was no expectation by Dirks' sources that he would keep their information in confidence. Nor did Dirks misappropriate or illegally obtain the information about [the corporation]." 463 U.S. at 665. *Dirks*, like *Chiarella*, rejected a "parity of information" rule. Those cases make clear that disparity of information between parties to a securities trade is not *per se* unfair, and so trading on the

advantage given by such a disparity, *without more*, is not "deceptive." See *id.* at 658-659. But in protecting informational disparities that are the product of *legitimate* activity, see *ibid.* (noting valuable "role of market analysts, which * * * is necessary to the preservation of a healthy market"), *Dirks* did not exempt from Section 10(b) the deceptive conversion of information for securities trading—a patently *illegitimate* activity.

Finally, *Central Bank* involved whether a private action under Section 10(b) and Rule 10b-5 may be brought for aiding and abetting a primary violation of those provisions. 511 U.S. at 167. The Court held that "a private plaintiff may not maintain an aiding and abetting suit under § 10(b)." *Id.* at 191. The Court then added that "[a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met." *Ibid.* The court of appeals relied on that statement as an indication that only purchasers and sellers are protected by Section 10(b). Pet. App. 15a. The context of the *Central Bank*'s discussion makes clear, however, that the Court was discussing only private liability under Section 10(b), in which the *Blue Chip Stamps* purchaser-seller rule applies. See pp. 25-26, *supra*. *Central Bank*, moreover, involved no issue of what deceptive conduct violates Section 10(b); the only issue was whether aiding and abetting another person's deception supports private liability under the provision. *Central Bank*'s rejection of private aiding and abetting liability has no bearing on whether the misappropriation theory is a valid basis for Section 10(b) liability.

C. The Misappropriation Theory Furthers Important Policies Of The Securities Laws And Has Been Accepted As Valid In Amendments To Those Laws

Trading on misappropriated information strikes at the heart of investor confidence in fair and honest securities markets, and it discourages legitimate investment in information gathering and analysis. Those concerns plainly implicate the "public interest" that the SEC may protect by forbidding trading on misappropriated information under Section 10(b) and Rule 10b-5. Congress has confirmed that view by enacting legislation that builds on the misappropriation theory. That legislation further supports the validity of the misappropriation theory.

1. "In the wake of the 1929 stock market crash and in response to reports of widespread abuses in the securities industry, the 73d Congress enacted two landmark pieces of securities legislation: the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act)." *Central Bank*, 511 U.S. at 170-171. The "basic goals" of the Exchange Act are "[t]o provide fair and honest mechanisms for the pricing of securities, to assure that dealing in securities is fair and without undue preferences or advantages among investors, * * * and to provide, to the maximum degree practicable, markets that are open and orderly." H.R. Conf. Rep. No. 229, 94th Cong., 1st Sess. 91-92 (1975).

An essential goal of the Exchange Act is the promotion of investor confidence in the fairness of the markets. See 15 U.S.C. 78b (regulation necessary "to insure the maintenance of fair and honest markets"). Section 10(b) furthers that aim by permitting the Commission to prohibit those "manipulative and deceptive practices which have been demonstrated to fulfill no useful function." S. Rep. No. 792, 73d Cong., 2d Sess. 6 (1934). The SEC has made the

judgment that trading on misappropriated information "undermines the integrity of, and investor confidence in, the securities markets." 45 Fed. Reg. 60,412 (1980). That judgment is sound. If investors knew that the SEC and the federal securities laws could not protect the markets against the use of illegally acquired information, and that no amount of research or skill could overcome their informational disadvantage, many would decline to participate in the markets at all, for they would know that they were playing a game in which the dice might, at any time, be loaded.[14] See Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 Harv. L. Rev. 322, 356 (1979); Nicholas Georgakopoulos, *Insider Trading as a Transactional Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation*, 26 Conn. L. Rev. 1, 19, 33 (1993). Other investors might demand risk premiums to compensate for the fear of overreaching, or engage in corrupt actions to overcome their informational disadvantages. "None of those responses is socially useful." Brudney, 93 Harv. L. Rev. at 356; see *id.* at 334-335. And capital formation would be impaired if investors left the securities markets because of lost confidence in the fairness of those markets (or demanded premiums to compensate for the risk of unfairness)—a point noted twice recently by congressional committees in the course of the enactment of increased sanctions for insider

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[14] The role of the SEC is vital to investor confidence, because, as this Court has noted, "Congress recognized that efficient regulation of securities trading could not be accomplished under a rigid statutory program. As part of the 1934 Act Congress created the Commission, which is provided with an arsenal of flexible enforcement powers." *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 195 (1976).

trading. H.R. Rep. No. 355, 98th Cong., 1st Sess. 2 (1983); H.R. Rep. No. 910, 100th Cong., 2d Sess. 8 (1988).[15]

The unfair advantage gained by misappropriation of information could also discourage securities analysts from competing lawfully for information and providing investors with valuable insights into the worth of specific companies. Indeed, the use of misappropriated information in the securities markets may discourage the creation of such information in the first place. See Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 Sup. Ct. Rev. 309, 313. And advance trading on misappropriated information can drive up the cost of transactions by increasing the price that the acquiring company must pay for tendered shares. See Bradford Cornell & Erik Sirri, *The Reaction of Investors and Stock Prices to Insider Trading*, 47 J. Fin. 1031, 1032-1033, 1045-1046 (1992); *SEC* v. *Maio*, 51 F.3d 623, 634 n.12 (7th Cir. 1995); *United States* v. *Newman*, 664 F.2d 12, 17-18 (1981), aff'd after remand, 722 F.2d 729 (2d Cir.) (Table), cert. denied, 464 U.S. 863 (1983). All those consequences harm the public interest, and all support the conclusion that liability for deceptive trading on misappropriated information is consistent with Section 10(b).

2. In 1988, Congress confirmed the validity of the misappropriation theory of liability, when it bolstered sanc-

[15] See also American Bar Ass'n, Comm. on Federal Regulation of Securities, *Report of the Task Force on Regulation of Insider Trading*, 41 Bus. Law. 223, 228 (1985); Steven R. Salbu, *Tipper Credibility, Noninformational Tippee Trading, and Abstention From Trading: An Analysis of Gaps in the Insider Trading Laws*, 68 Wash. L. Rev. 307, 328 n.117 (1993); John W. Bagby, *The Evolving Controversy Over Insider Trading*, 24 Am. Bus. L.J. 571, 579 n.55 (1987) (quoting Arthur Levitt, Jr., then chairman of the American Stock Exchange).

tions for insider trading.[16] In the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), Pub. L. No. 100-704, § 2(1), 102 Stat. 4677, Congress declared:

> [T]he rules and regulations of the Securities and Exchange Commission under the Securities Exchange Act of 1934 governing trading while in possession of material, nonpublic information are, as required by such Act, necessary and appropriate in the public interest and for the protection of investors.

The House Report accompanying ITSFEA makes clear that Congress intended to validate the misappropriation theory of liability under Rule 10b-5, which is one of the SEC's rules "governing trading while in possession of material, nonpublic information."[17] Following a discussion of *Chiarella*, *Dirks*, *Carpenter*, and the Second Circuit cases upholding the misappropriation theory, the House Report stated: "Under current case law, the SEC must es[t]ablish that the person misusing the information has breached either a fiduciary duty to shareholders or *some other duty* not to misappropriate insider information." H.R. Rep. No. 910, *supra*, at 10 (emphasis added). The

[16] Previously, a 1983 House Report accompanying the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264, cited with approval a Second Circuit decision upholding the misappropriation theory as a valid basis for liability, and noted that the law in this area was "well-developed." H.R. Rep. No. 355, *supra*, at 5 n.8, 13 & n.20. The Report explained that, "[i]n other areas of the law, deceitful misappropriation of confidential information by a fiduciary * * * has consistently been held to be unlawful," and stated that Congress "has not sanctioned a less rigorous code of conduct under the federal securities laws." *Id.* at 5.

[17] Congress also intended that enactment to validate Rule 14e-3(a). See pp. 44-45, *infra*.

fraud should be encompassed within Section 10(b) and Rule 10b-5." *Ibid.*[18]

Congress's validation of the misappropriation theory is also evident from its enactment in ITSFEA of a new Section 20A(a) of the Exchange Act, 15 U.S.C. 78t-1(a). Section 20A(a) provides an express cause of action against any person who violates the Exchange Act "by purchasing or selling a security while in possession of material, nonpublic information," for the benefit of "any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased * * * or sold * * * securities of the same class." Section 20A(a) was "specifically intended to overturn court cases which have precluded recovery for plaintiffs where the defendant's violation is premised upon the misappropriation theory." H.R. Rep. No. 910, *supra*, at 26. In particular, Section 20A(a) rejected the result in *Moss* v. *Morgan Stanley Inc.*, 719 F.2d 5 (2d Cir. 1983), cert. denied, 465 U.S. 1025 (1984), in which the court of appeals held that a Rule 10b-5 plaintiff had no cause of action against employees of an investment bank who had purchased a company's stock based on misappropriated nonpublic information that the bank's client intended to launch a tender

[18] Although Congress did not define "insider trading" in ITSFEA, the House Report noted that the Committee was concerned that a statutory definition of that concept could be inadvertently *narrowing*. See H.R. Rep. No. 910, *supra*, at 11. The Committee emphasized that "[t]he legal principles governing insider trading cases" were already "well-established and widely-known," and therefore did not require additional definition. *Ibid.* In context, the Committee Report makes clear that "insider trading," as that term was used in the Report, included "trading and tipping by persons who misappropriate material nonpublic information from sources other than market participants." *Id.* at 10 (discussing *Carpenter*).

offer for that company.[19] In recommending that Congress create the right of recovery rejected in *Moss*, the Committee stated that "the misappropriation theory fulfills appropriate regulatory objectives in determining when communicating or trading while in possession of material nonpublic information is unlawful." H.R. Rep. No. 910, *supra*, at 26-27; see also *id.* at 38-39.

This Court has observed that, "once an agency's statutory construction has been 'fully brought to the attention of the public and the Congress,' and the latter has not sought to alter that interpretation although it has amended the statute in other respects, then presumably the legislative intent has been correctly discerned." *United States* v. *Rutherford*, 442 U.S. 544, 554 n.10 (1979) (citation omitted). In 1988, Congress not only declined to alter the misappropriation theory after considering it closely, it expressly declared approval of that doctrine by positive legislation. See *Red Lion Broadcasting Co.* v. *FCC*, 395 U.S. 367, 380-382 (1969). Accordingly, there is no basis for concluding that the misappropriation theory is inconsistent with Section 10(b).

[19] Although the Second Circuit had previously upheld the misappropriation theory of liability as applied to the same transactions in a criminal prosecution, see *Newman*, *supra*, the court of appeals held that, under *Chiarella*, even though the defendants had committed securities fraud, they had no duty of disclosure to the target's shareholders, as to whom they were "complete stranger[s] who dealt with the sellers * * * only through impersonal market transactions." *Moss*, 719 F.2d at 13 (quoting *Chiarella*, 445 U.S. at 232-233).

II. THE SEC VALIDLY PROMULGATED RULE 14e-3(a) PURSUANT TO ITS RULEMAKING AUTHORITY IN SECTION 14(e) OF THE EXCHANGE ACT

Respondent was convicted of violating Section 14(e) of the Exchange Act and SEC Rule 14e-3(a). Rule 14e-3(a) prohibits anyone (other than the bidder) who possesses material, nonpublic information about a tender offer, which he knows or has reason to know is obtained from the bidder, the target, or an insider or adviser of either, from trading in the shares of companies that will be involved in that tender offer absent public disclosure of the information and its source. A violation of Rule 14e-3(a) does not require proof that the person who traded breached a fiduciary duty in trading, or in acquiring the inside information; it requires only that the person traded while in possession of the nonpublic information.

Because Congress expressly delegated rulemaking authority to the SEC in Section 14(e), Rule 14e-3(a) is valid unless it is "arbitrary, capricious, or manifestly contrary to the statute." *Chevron U.S.A Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984); *Batterton* v. *Francis*, 432 U.S. 416, 424-426 (1977) (legislative regulations are entitled to "more than mere deference or weight"). The court of appeals held that, because Rule 14e-3(a) does not require a breach of fiduciary duty, it exceeds the SEC's rulemaking authority under Section 14(e). Pet. App. 24a-36a. That conclusion is incorrect.

A. The SEC's Rulemaking Power Under Section 14(e) Is Not Limited To Regulating Common Law Fraud Or Practices Covered By Section 10(b)

Section 14(e), which was enacted by Congress as part of the Williams Act in 1968, Pub. L. No. 90-439, § 3, 82 Stat.

457, makes it unlawful "to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer." Section 14(e)'s second sentence, added in the 1970 amendments to the Williams Act, see Act of Dec. 22, 1970, Pub. L. No. 91-567, § 5, 84 Stat. 1497-1498, provides further that the SEC "shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative." Section 14(e) thus contains, in the first sentence, a self-operative prohibition against fraud, and contains, in the second sentence, a grant of rulemaking authority to the SEC to delineate the "acts and practices" that shall be considered "fraudulent" within the meaning of Section 14(e) and also to prescribe means reasonably designed to prevent them.

1. The language and structure of Section 14(e) make clear that the SEC's rulemaking authority is not limited, as the court of appeals believed (Pet. App. 28a-29a), to proscribing traditional fraud committed in derogation of fiduciary duties. A reading of Section 14(e) restricting the SEC to "defin[ing]" fraud exactly as courts have already done under the common law renders its defining authority superfluous, in light of Section 14(e)'s self-operative prohibition against "fraudulent * * * acts or practices." That construction would conflict with the settled principle that courts must "give effect, if possible, to every clause and word of a statute." *United States* v. *Menasche*, 348 U.S. 528, 538-539 (1955). The "delegation of rulemaking responsibility [would] become[] a hollow gesture * * because the SEC could never define as fraud anything not already prohibited by the self-operative provision." *United States* v. *Chestman*, 947 F.2d 551, 558 (2d Cir. 1991) (opinion of Meskill, J.), cert. denied, 503 U.S. 1004 (1992).

The court of appeals also believed that the SEC's authority to define fraud under Section 14(e) could reach no further than its authority under Section 10(b). Pet. App. 30a-32a. For that conclusion, the court relied on *Schreiber* v. *Burlington Northern, Inc.*, 472 U.S. 1, 10 & n.10 (1985), where this Court remarked that Section 14(e)'s "broad antifraud prohibition" was "modeled on § 10(b) and Rule 10b-5." *Schreiber*, however, involved only acts that were alleged to violate the self-operative prohibition in the first sentence of Section 14(e)—which does contain language similar to Section 10(b). That case did not involve the SEC's authority in Section 14(e) to define fraudulent acts by regulation.[20]

The express rulemaking authority conferred by Section 14(e) goes well beyond that found in Section 10(b). While Section 10(b) authorizes the SEC only to proscribe "manipulative or deceptive device[s] or contrivance[s]," the second sentence of Section 14(e) authorizes the SEC to "define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."[21] The textual difference between the two sections results from the fact that Section 14(e)'s rulemaking provision was modeled not on Section 10(b), but on Section 15(c)(2) of the Exchange Act, 15 U.S.C. 78*o*(c)(2). See S. Rep. No. 1125, 91st Cong., 2d Sess. 4 (1970); *Additional Consumer Protection in Corporate Takeovers and Increasing the Securities Act Exemptions*

[20] Moreover, *Schreiber* involved acts alleged to be "manipulative" rather than "fraudulent," and the Court has noted that "manipulative" (unlike "fraudulent") is "virtually a term of art when used in connection with the securities markets." 472 U.S. at 6.

[21] The scope of Section 14(e) is, however, narrower than that of Section 10(b), in that Section 14(e) applies only to acts and practices in connection with tender offers. Section 10(b) prohibits fraud "in connection with the purchase or sale of any security."

for Small Businessmen: Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 91st Cong., 2d Sess. 10 (1970) (testimony of SEC Chairman Budge) (*Additional Consumer Protection*). Section 15(c)(2)(D) authorizes the SEC to "define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative" by broker-dealers in the over-the-counter market—the same broad language as is found in Section 14(e).[22]

Congress enacted Section 15(c)(2) in 1936 because it believed that the SEC's rulemaking authority under Section 10(b), part of the original 1934 Act, was inadequate to deal with the problem of broker-dealer overreaching. Section 15(c)(2) authorized the SEC to "define" fraud with respect to broker-dealers in the over-the-counter market, and thereby subjected broker-dealers to more than "the general concepts of fraud which are already in the statute." *Unlisted Securities: Hearing on S. 4023 Before the House Comm. on Interstate and Foreign Commerce*, 74th Cong., 2d Sess. 14 (1936) (testimony of SEC Chairman Landis); see also H.R. Rep. No. 2307, 75th Cong., 3d Sess. 11 (1938). When Congress added the same language to Section 14(e),

[22] When Congress enacted Section 14(e)'s rulemaking provision in 1970, the Commission had already used its rulemaking authority under Section 15(c)(2) to define as "fraudulent, deceptive, or manipulative act[s] or practice[s]" a number of practices that had not constituted common law fraud. See 17 C.F.R. 240.15c2-1 (1970) (proscribing the hypothecation of customer securities by a broker-dealer where hypothecated securities would be commingled); 17 C.F.R. 240.15c2-3 (1970) (proscribing transactions by broker-dealers in unvalidated German securities); 17 C.F.R. 240.15c2-4 (1970) (requiring the prompt transmittal of funds received by broker-dealers in connection with the distribution of securities); 17 C.F.R. 240.15c2-5 (1970) (requiring written disclosure of credit terms and commissions and customer suitability determination in connection with the sale of securities on margin by broker-dealers).

it similarly gave the SEC "full rulemaking powers," which it considered an "utmost necessity," to prevent overreaching in the tender offer context. See 116 Cong. Rec. 3024 (1970) (remarks of Sen. Williams). The history of Section 14(e)'s grant of rulemaking authority thus establishes that it authorizes the SEC to go beyond the limitations of the pre-existing prohibitions against fraud.

2. Rule 14e-3(a) is also supported by the Commission's power under Section 14(e) to "prescribe means reasonably designed to prevent" fraud. That authority "necessarily encompasses the power to proscribe conduct outside the purview of fraud, be it common law or SEC-defined fraud." *Chestman*, 947 F.2d at 558 (opinion of Meskill, J.); *Maio*, 51 F.3d at 635 ("The power to define and prescribe means 'reasonably designed to prevent' fraudulent, deceptive, or manipulative acts and practices must extend further than the mere proscription of acts and practices that are in fact fraudulent, deception, or manipulative; otherwise this language is superfluous."). This Court recognized in *Schreiber* that Section 14(e) gives the Commission "latitude to regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts." 472 U.S. at 11 n.11. The court of appeals stated, however, that, "[p]roperly read, this provision means simply that the SEC has broad regulatory powers in the field of tender offers, but the statutory terms have a fixed meaning which the SEC cannot alter by way of an administrative rule." Pet. App. 35a. That statement overlooks the fact that the SEC's rulemaking power to adopt "means reasonably designed to prevent" fraud necessarily authorizes prophylactic requirements that may sweep more broadly than the underlying prohibitions in order to ensure that the forbidden "deceptive acts" do not occur.

B. Rule 14e-3(a) Is A Valid Exercise Of The SEC's Rulemaking Authority

Rule 14e-3(a) is a valid exercise of the SEC's authority to "define * * * such acts and practices as are fraudulent, deceptive, or manipulative" in the tender offer context, and to "prescribe means reasonably designed to prevent" fraud. The Rule is a reasonable, and indeed necessary, means of accomplishing Congress's objectives in the Williams Act. It therefore satisfies the deferential standard of review applicable to legislative rules. See *Chevron*, *supra*; *Batterton*, *supra*.

Congress enacted the Williams Act to ensure "full disclosure" of information to investors in the tender offer context. See *Schreiber*, 472 U.S. at 8-11; 113 Cong. Rec. 24,664 (1967) (remarks of Sen. Williams); H.R. Rep. No. 1711, 90th Cong., 2d Sess. 11 (1968); S. Rep. No. 550, 90th Cong., 1st Sess. 11 (1967). The Williams Act accordingly requires that persons "engaged in making or opposing tender offers *or otherwise seeking to influence the decision of investors* or the outcome of the tender offer" must make full disclosure of material information in their possession before trading (or abstain from trading). *Schreiber*, 472 U.S. at 11 (quoting H.R. Rep. No. 1711, *supra*, at 11) (emphasis added).

Rule 14e-3(a) is aimed directly at those who would unfairly "influence the decision of investors" by trading on the basis of material, nonpublic information about a tender offer derived from inside sources. Trading on inside information about a tender offer frustrates Congress's intent to preserve a "neutral setting," such that investors can fully evaluate the benefits and disadvantages of the offer. *Schreiber*, 472 U.S. at 9; see 45 Fed. Reg. 60,412 (1980). Accordingly, Rule 14e-3(a) sets forth a "disclose or abstain" rule: "In order to avoid the prohi-

bition on trading, there must be public disclosure within a reasonable time prior to any such purchase or sale. This public disclosure may be made by the person who has acquired information subject to the prohibition or by another person." *Id.* at 60,413.[23]

The "full disclosure" for investors and the "neutral setting" intended by the Williams Act implicate situations well beyond those in which a trader has misappropriated information about a tender offer in violation of a fiduciary duty. As the SEC noted in an extensive 1971 study of the role of institutional investors in the securities markets, bidding companies may pass information about planned tender offers to favored investors, in the hope that those investors would purchase large blocks of stock and ally themselves with the bidder in the contest for corporate control (or in subsequent issues of corporate management).[24] Those investors, armed with critical information about a planned takeover bid, would have an unfair advantage over others in the market, even if their use of that information to purchase stock in the target company were not a breach of a fiduciary duty to the *source* of the information (and, indeed, had been encouraged by the

[23] Disclosure of the inside information before trading, therefore, obviates the trader's liability under Rule 14e-3(a). 45 Fed. Reg. 60,414 (1980). Disclosure does not, however, eliminate the trader's liability under state law for misappropriating the inside information. *Id.* at 60,413. In practical effect, therefore, abstention from trading may be the only lawful alternative to persons in possession of material, nonpublic information about tender offers. *Ibid.* But Rule 14e-3(a) itself imposes an obligation to disclose or abstain, not a flat obligation to abstain, and there may be situations in which a trader is free to disclose the information without liability to the source.

[24] See *Institutional Investor Study Report of the Securities and Exchange Commission*, H.R. Doc. No. 64, 92d Cong., 1st Sess. Pt. 1, at xxxi-xxxiii (1971); *id.* Pt. 8, at 125-127; see also 45 Fed. Reg. 60,412 (1980).

source). As the Court noted in *Chiarella*, such tipping and use of information to purchase shares in target companies, known as "warehousing," was prohibited by the SEC because "the seller's behavior presumably would be altered if he had the nonpublic information." 445 U.S. at 234.

Congress was aware of the unfairness of such insider trading when in 1970 it authorized the SEC to promulgate rules to define and prevent fraud in connection with tender offers. When Senator Williams asked the SEC for examples of deleterious practices that the proposed rulemaking authority would be used to prevent, the SEC described a situation in which a "person who has become aware that a tender bid is to be made, or has reason to believe that such bid will be made, may fail to disclose material facts with respect thereto to persons who sell to him securities for which the tender bid is to be made." *Additional Consumer Protection* 12. "Notably, this hypothetical does not contain any requirement that the trader breach a fiduciary duty." *Chestman*, 947 F.2d at 559 (opinion of Meskill, J.). Accordingly, there is every reason to believe that Congress intended to authorize the SEC to prohibit the misuse of inside information with respect to tender offers by persons other than fiduciaries.

Rule 14e-3(a) is also "reasonably designed to prevent" instances of fraud in tender offers. Material, nonpublic information relating to a tender offer necessarily is circulated to many people, such as attorneys, investment bankers, and accountants, involved in structuring the transaction. The availability of that information may lead to abuse because "even a hint of an upcoming tender offer may send the price of the target company's stock soaring." *SEC* v. *Materia*, 745 F.2d 197, 199 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985). Trading on such information most likely will involve a breach of a duty of confidentiality to the bidder or target company, or to persons repre-

senting either party. But it may be "almost impossible to prove that the trader obtained such information in breach of a fiduciary duty owed either by the trader or by the ultimate insider source of the information." *SEC* v. *Peters*, 978 F.2d 1162, 1167 (10th Cir. 1992). The difficulties of establishing such a breach may permit sophisticated insider trading to go unpunished. Rule 14e-3(a) avoids those problems by prohibiting a class of securities transactions in which the likelihood that such a breach of duty has occurred is great, without requiring specific proof of a breach of fiduciary duty. The Rule is therefore a "means reasonably designed to prevent" fraudulent trading on material, nonpublic information in the tender offer context.

C. Congressional Action Has Validated Rule 14e-3(a)

As with the misappropriation doctrine under Section 10(b), action by Congress since the promulgation of Rule 14e-3(a) has confirmed the Rule's validity. In 1983, a committee report on a bill to strengthen sanctions against insider trading (which was eventually enacted) specifically noted Rule 14e-3 and proposed no changes to it.[35] In 1988, Congress passed ITSFEA and, in it, expressly ratified the SEC's "rules * * * governing trading while in possession of material, nonpublic information." See pp. 32-35, *supra*. Congress was, of course, well aware that Rule 14e-3 was such a rule. See H.R. Rep. No. 910, *supra*, at 14 (discussing role of Rule 14e-3 in combatting insider trading, by inducing firms to establish supervisory systems to detect such trading and control the flow of sensitive information that might be misused). Accordingly, Rule

[35] See H.R. Rep. No. 355, *supra*, at 4. The bill discussed in the Report became the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264.

14e-3 was brought to the attention of Congress and validated by that body. That action confirms that the Rule is consistent with the SEC's authority under Section 14(e).

III. RESPONDENT'S MISAPPROPRIATION OF CONFIDENTIAL INFORMATION TO TRADE IN SECURITIES VIOLATED THE MAIL FRAUD STATUTE

1. The mail fraud statute, 18 U.S.C. 1341, prohibits the use of the mails "for the purpose" of furthering "any scheme or artifice to defraud." In *Carpenter* v. *United States*, 484 U.S. 19 (1987), this Court held that a reporter's scheme to misappropriate his employer's confidential business information for securities trading constituted a "scheme or artifice to defraud" in violation of the mail fraud statute. The Court concluded that, because the reporter had obtained the confidential business information in the course of his employment, his unauthorized use of that information for personal gain amounted to fraudulent activity proscribed by the mail fraud statute. *Id.* at 27-28 (citing *Snepp* v. *United States*, 444 U.S. 507, 515 n.11 (1980) (per curiam)). The Court explained that "a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his own personal benefit but must account to his principal for any profits derived therefrom." *Ibid.*

Respondent's misappropriation of the confidential information that a Dorsey client planned to make a tender offer for Pillsbury stock was no less fraudulent than the reporter's misappropriation of the confidential business information in *Carpenter*. Because respondent obtained that information in the course of his employment with Dorsey, he was bound not to use it in a manner not

authorized by his law firm. As a Dorsey partner, he was also bound not to use the confidential information about the takeover in a manner not authorized by the client. Respondent nevertheless deceived his firm and its client by posing as a faithful attorney working for his firm's and client's interests. Respondent's use of the information to trade in Pillsbury securities for his personal gain deprived Dorsey and Grand Met of the right to use the confidential information exclusively for the purpose for which the information had been entrusted to the law firm, and therefore amounted to fraud on the firm and the client.

2. The court of appeals' reversal of respondent's mail fraud convictions cannot be reconciled with this Court's decision in *Carpenter*. The court of appeals concluded that the mail fraud convictions could not stand because "the indictment was structured in such a manner as to premise the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud." Pet. App. 37a. The court of appeals reasoned that, because respondent's "conduct did not constitute securities fraud, * * * there was no fraud upon which to base the mail fraud charges." *Ibid.*

Carpenter establishes, however, that a person who misappropriates confidential business information in breach of a fiduciary duty and then trades on it in the securities markets has engaged in a scheme to defraud within the mail fraud statute, whether or not the identical conduct violates the securities laws. In *Carpenter*, the Court noted that the same "appropriation of confidential information [owned by the *Journal*] * * * underlay both the securities laws and mail and wire fraud counts." 484 U.S. at 24. And although the Court was evenly divided with respect to the convictions under the securities laws in *Carpenter*, it unanimously affirmed the mail and wire fraud convictions. *Ibid.* Thus, *Carpenter* makes clear

that mail fraud charges are independent of securities fraud charges, even when both rest on the same set of facts.

Although the conduct that constituted the charged scheme to defraud—namely, respondent's misappropriation of confidential information about Grand Met's plan to make a tender offer for Pillsbury stock—was essentially the same for purposes of both the securities and mail fraud counts in this case, the indictment did not make the mail fraud counts dependent on the securities fraud counts. The mail fraud counts did not charge, as an element of the offense, that respondent had committed mail fraud by using the mails to commit violations of the securities laws. Rather, the indictment set forth the acts that were alleged to form the scheme to defraud, and then charged, in separate counts, first, that those acts violated the mail fraud statute, and second, that the acts violated the securities fraud statutes. See J.A. 8-23.[26] Further, the district court instructed the jury on the mail fraud counts separately from the securities fraud counts, and gave the jury no indication that proof of a mail fraud violation was dependent on proof of a securities law violation. See J.A. 192-194. Indeed, the court concluded the mail fraud instructions before even describing the elements of the violations under the securities laws. J.A. 194. Accordingly, respondent's conviction on the mail fraud count was in no way dependent on a finding that he violated the securities laws.

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[26] The indictment in *Carpenter* was drawn in the same way. See 86-422 J.A. 1-13 (setting forth the means and objects of the conspiracy), 15 (¶ 39) (charging those means and objects as part of the scheme in violation of Rule 10b-5), 17 (¶ 42) (charging those means and objects as part of the scheme in violation of the wire fraud statute), 20 (¶ 45) (charging those means and objects as part of the scheme in violation of the mail fraud statute).

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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FEBRUARY 1997

APPENDIX

1. Section 1341 of Title 18, United States Code, provides:

§ 1341. Frauds and swindles

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article, for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or deposits or causes to be deposited any matter or thing whatever to be sent or delivered by any private or commercial interstate carrier, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail or such carrier according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined under this title or imprisoned not more than five years, or both. If the violation affects a financial institution, such person shall be fined not more than $1,000,000 or imprisoned not more than 30 years, or both.

2. Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. 78j, provides, in pertinent part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

3. Section 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. 78n(e), provides:

(e) Untrue statement of material fact or omission of fact with respect to tender offer

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The [Securities and Exchange] Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to

prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

4. Section 20A(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78t-1(a), provides:

(a) Private rights of action based on contemporaneous trading

Any person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.

5. Section 2 of the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677, 15 U.S.C. 78u-1 note, provides:

The Congress finds that —

(1) the rules and regulations of the Securities and Exchange Commission under the Securities Exchange Act of 1934 [15 U.S.C. 78a et seq.] governing trading while in possession of material, nonpublic information are, as required by such Act, necessary and appropriate in the public interest and for the protection of investors;

(2) the Commission has, within the limits of accepted administrative and judicial construction of such rules and regulations, enforced such rules and regulations vigorously, effectively, and fairly; and

(3) nonetheless, additional methods are appropriate to deter and prosecute violations of such rules and regulations.

6. Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. 240.10b-5, provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

7. Rule 14e-3(a) of the Securities and Exchange Commission, 17 C.F.R. 240.14e-3(a), provides:

(a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive, or manipulative act or practice within the meaning of section 14(e) of the [Securities Exchange] Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is

nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

(1) The offering person,

(2) The issuer of the securities sought or to be sought by such tender offer, or

(3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

(12)

No. 96-843

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In the Supreme Court of the United States

October Term, 1996

UNITED STATES OF AMERICA,

Petitioner,

v.

JAMES HERMAN O'HAGAN,

Respondent.

On Writ Of Certiorari To The
United States Court Of Appeals
For The Eighth Circuit

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QUESTIONS PRESENTED

1. Whether the misappropriation theory -- which allows a finding of criminal liability for trading in securities on material, nonpublic information in breach of fiduciary duties owed to the source of the information, in the absence of any evidence of a misrepresentation or nondisclosure to, and which induces action or inaction on the part of, a purchaser or seller of the securities or any other participant in the securities transaction -- is encompassed within the text of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b).

2. Whether the Securities and Exchange Commission exceeded its rulemaking authority under §14(e) of the Securities Exchange Act of 1934, 15 USC 78n(e), in promulgating Rule 14e-3(a), 17 C.F.R. §240.14e-3(a), without requiring a breach of fiduciary duty and by extending §14(e) to prohibit trading in advance of a tender offer if "substantial steps" have been taken toward the tender offer.

3. Whether, *in this particular case*, the indictment was structured in such a way as to premise the mail fraud counts on the acts allegedly constituting the securities fraud such that a reversal of the securities fraud counts necessarily compels reversal of the mail fraud counts.

TABLE OF CONTENTS

Page

Statement 1

The Opinion of the Court of Appeals 7

Summary of Argument 8

Argument:

I. The misappropriation theory is an invalid extension of §10(b) 12

A. The misappropriation theory is not encompassed within the text of §10(b), nor can it be reconciled with this Court's interpretations of the statute 14

1. The misappropriation theory does not require deception within the meaning of §10(b) but instead turns on a showing of a conversion in breach of a fiduciary duty 15

2. The misappropriation theory does not satisfy the "in connection with" requirement of §10(b) 22

B. Criminal convictions under the misappropriation theory violate due process because an uncodified "theory" cannot provide adequate guidance as to what conduct is illegal 30

II. The SEC exceeded its rulemaking authority when it promulgated Rule 14e-3 33

A. The language of §14(e) constrains the SEC's rulemaking authority by the common law definition of fraud 34

B. The legislative history of §14(e) does not indicate that Congress intended to authorize the SEC to redefine fraud 39

Page

C. Rule 14e-3 improperly extends §14(e) to prohibit trading in advance of a tender offer, without providing notice as to when a violation occurs and without requiring scienter 41

III. Congressional acquiescence in, or "validation" of, the misappropriation theory and Rule 14e-3 is no substitute for legislative codification 44

IV. The reversal of respondent's mail fraud convictions does not contravene *Carpenter* 48

Conclusion 51

Appendix 1a

TABLE OF AUTHORITIES

Cases:

Anaconda Co. v. Crane Co., 411 F. Supp. 1210 (S.D.N.Y. 1975) 42

Applied Digital Data Systems, Inc. v. Milgo Electric Corp., 425 F. Supp. 1145 (S.D.N.Y. 1977) 42

Ashwander v. TVA, 297 U.S. 288 (1936) 30

Babbitt v. Sweet Home Chapter of Communities for a Great Or., __U.S.__, 115 S. Ct. 2407 (1995) 8

Berman v. Gerber Products Co., 454 F. Supp. 1310 (W.D. Mich. 1978) 42

Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) 12, 13, 14, 23, 28, 34

Brown v. Gardner, 115 S. Ct. 552 (1994) 45

Buckley v. Valeo, 424 U.S. 1 (1976) 8, 30

Cady, Roberts & Co., In re, 40 S.E.C. 907 (1961) 13, 40

Calder v. Bull, 3 Dall. 386 (1798) 47

Carpenter v. United States, 484 U.S. 19 (1987) 12, 17, 48, 50

Central Bank, N.A. v. First Interstate Bank, N.A., 511 U.S. 164 (1994) ..... *passim*

Page

Chevron, U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984) 34

Chiarella v. United States, 445 U.S. 222 (1980) ..... *passim*

Crandon v. United States, 494 U.S. 152 (1990) 33

Crane Co. v. Anaconda Co., 411 F. Supp. 1208 (S.D.N.Y. 1975) 42

Dirks v. SEC, 463 U.S. 646 (1983) ..... *passim*

Dunn v. Commodity Futures Trading Commission, __U.S.__, 117, S. Ct. 913 (1997) 9, 10, 22, 34, 38, 39, 45

Edward J. DeBartolo Corp. v. Florida Gulf Coast Building & Construction Trades Council, 485 U.S. 568 (1988) 30

Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) 14, 15, 18, 25, 33, 34, 41, 43

Frankel v. Slotkin, 705 F. Supp. 105 (E.D.N.Y. 1989) 42

Grayned v. City of Rockford, 408 U.S. 104 (1972) 10, 30, 44

Grin v. Shine, 187 U.S. 181 (1902) 17

Gustafson v. Alloyd Co., 115 S. Ct. 1061 (1995) 35, 41

Hynes v. Oradell, 425 U.S. 610 (1976) 8

IBT v. Daniel, 439 U.S. 551 (1979) 34

ICM Realty v. Cabot, Cabot & Forbes Land Trust, 378 F. Supp. 918 (S.D.N.Y. 1974) 42

Kolender v. Lawson, 461 U.S. 352 (1983) 30

Aaron v. SEC, 446 U.S. 680 (1980) 25, 34, 43, 46

Lewis v. McGraw, 619 F.2d 192 (2d Cir.), cert. denied, 449 U.S. 951 (1980) 42

Lynce v. Mathis, __ U.S. __, 117 S. Ct. 891 (1997) 33

Manhattan General Equipment Co. v. Commissioner, 297 U.S. 129 (1936) 33, 34, 43, 47

Missouri Portland Cement Co. v. H.K. Porter Co., 535 F.2d 388 (8th Cir. 1976) 42

Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984) 47

Mourning v. Family Publications Service, Inc., 411 U.S. 356 (1973) 8

Page

Musick, Peeler & Garrett v. Employers Insurance of Wausau, 508 U.S. 286 (1993) 36
Parr v. United States, 363 U.S. 370 (1960) 50
Piper v. Chris-Craft Industrial, Inc., 430 U.S. 1(1977) 11, 41
Presley v. Etowah County Commission, 502 U.S. 491 (1992) 34
Reliance Electric Co. v. Emerson Electric Co., 404 U.S. 418 (1972) 34
Rewis v. United States, 401 U.S. 808 (1971) 22
Rivers v. Roadway Express, 114 S. Ct. 1510 (1994) 46
Rondeau v. Mosinee Paper Corp., 422 U.S. 49 (1975) 42
SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991), *cert. denied*, 502 U.S. 1071 (1992) 13
SEC v. Lenfest, 949 F. Supp. 341 (E.D. Pa. 1996) 14, 15
SEC v. Mayhew, 916 F. Supp. 123 (D. Conn. 1995) 42, 43
SEC v. Sloan, 436 U.S. 103 (1978) 34, 46
SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) 40
Sanders v. Thrall Car Manufacturing, 582 F. Supp. 945 (S.D.N.Y. 1983) 42
Santa Fe Industries v. Green, 430 U.S. 462 (1977) 9, 14, 15, 16, 17, 18, 19, 22, 25, 26
Schmuck v. United States, 409 U.S. 705 (1989) 50
Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985) 10, 35, 36, 37, 38, 39, 41
Securities Industrial Association v. Board of Governors, 468 U.S. 137 (1984) 34
Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971) 26
Susquehanna Corp. v. Pan America Sulphur Co., 423 F.2d 1075 (5th Cir. 1970) 42
United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975) 34
United States v. Aguilar, __ U.S. __, 115 S. Ct. 2357 (1995) 30, 44

Page

United States v. Bryan, 58 F.3d 933 (4th Cir. 1995) 14, 23, 26, 27, 28, 29, 31
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United States v. Kozminski, 487 U.S. 931 (1988) 32, 43
United States v. Naftalin, 441 U.S. 768 24
United States v. O'Hagan, 92 F.3d 612 (8th Cir. 1996) ..... *passim*
United States v. Turley, 352 U.S. 407 (1957) 37
United States v. X-Citement Video, 513 U.S. 64 (1994) 47

Statutes and regulations:

15 U.S.C. §77e 40
15 U.S.C. §78t(d) 46
15 U.S.C. §79t 33
15 U.S.C. §78j(b) 7, 35
15 U.S.C. §78o(c)(2) 37
15 U.S.C. §78n(e) 8, 35, 40
17 C.F.R. §240.14e-3(a) 8, 42
17 C.F.R. §240.10b-5 ..... 12, 15

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Page

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Restatement of Torts §§525, 531 (1938) 15, 16
Restatement (Second) of Torts §551 ..... 10, 16, 27, 36

STATEMENT

The government appeals the reversal by the Eighth Circuit Court of Appeals of a judgment of conviction entered against respondent on a 57 count indictment, each count of which was based on a single predicate act -- the purchase by respondent of Pillsbury stock and call options during a period of time in which Pillsbury was widely and publicly reported to be a takeover target. Due to the fact-intensive nature of the "theories" advanced by the government in this *criminal* appeal, respondent is compelled to clarify the record.

Respondent is a former attorney whose investment in Pillsbury securities appreciated in value when Grand Met acquired Pillsbury. The government's theory of the case is that -- despite the fact that respondent began investing in Pillsbury in July 1988, based on solicitations from his brokers -- respondent's investments dated after August 26, 1988, were completed while respondent was in possession of material, nonpublic information that he learned while a partner at Dorsey & Whitney, a large Minneapolis law firm ("Dorsey"). The government alleges that by purchasing Pillsbury stock and call options, respondent breached a fiduciary duty to the Dorsey firm and to Dorsey's client, Grand Met, and thereby violated the securities laws.

The government offered no evidence to support its claim that respondent traded in Pillsbury securities on the basis of material, nonpublic information obtained from his law firm other than a single conversation which allegedly took place between Dorsey partner Thomas Tinkham and respondent on, or slightly before, August 26, 1988, concerning the Dorsey firm's representation of an undisclosed client of the law firm of Cravath, Swaine & Moore ("Cravath")[1] in connection with a possible acquisition of the

[1] Because the Dorsey firm opened its file on the matter as "Cravath, Re: General," without reference to the name of either Grand Met or Pillsbury, the firm's bookkeeping department was not notified that the firm's representation involved Pillsbury. Dorsey's managing partner testified that, consistent with the firm's policy regarding securities trading, *any* member of the firm was free to trade in Pillsbury securities in July through September 1988. (JA 32-33, 122).

Pillsbury Company.[2] The government alleges that, in that August 26 conversation, respondent *confirmed* what he had previously learned: that Dorsey was representing an undisclosed client in connection with a possible acquisition of Pillsbury. (Govt. Br. at 4 n.1). The government concedes, however, that it cannot prove when or from whom or by what means respondent first obtained the "material, nonpublic information" on which he is alleged to have traded.[3]

The facts leading up to the alleged conversation with Tinkham are, for the most part, undisputed. Respondent began investing in Pillsbury on July 27, 1988, when a broker, based on takeover rumors, solicited respondent for a 5,000-share purchase of Pillsbury stock for a total of approximately $180,000.[4] (JA 174-75). On August 18, 1988, another broker, James Consideine, advised respondent that he had received a $9 million order to purchase 250,000 shares of Pillsbury at the market from a London, England account. (JA 164-67). Based on this information, publicly circulated rumors, and the solicitations of other brokers, respondent decided to take the exact same position in Pillsbury as Consideine's customer. (JA 37-51). Since respondent did not have or want to risk $9 million, however, he decided to buy 2500 call options with limit orders and thereby control 250,000 shares.[5]

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[2] Respondent contends that the conversation with Tinkham occurred on September 21, 1988, rather than on August 26, 1988, but the difference is not central to this appeal because Respondent placed all of his options orders before August 26, 1988.

[3] In this regard, prosecutor Bebel admitted at the close of the government's case that: "There's no *specific evidence* as to the manner in which he *first obtained* the evidence, as to whether it was by conversation or by documentation." (JA 168 (emphasis added)).

[4] Respondent was very active in the stock market and, on August 1, 1988, weeks before the alleged conversation with Tinkham, held positions in listed securities with a value of approximately $5 million. (Trial Transcript ("Tr.") Vol. II, p. 39).

[5] The government's expert, Judy Kallaus, testified that this is a common investment strategy. (Tr. Vol. V, p. 205).

With the exception of one order for 5,000 shares of Pillsbury stock that was confirmed on September 20, 1988, (JA 154), respondent's orders for Pillsbury stock or call options were placed *prior* to August 26, 1988 -- the date on which the government alleges respondent acquired the material, nonpublic information which gives rise to its claims of securities fraud.[6] Respondent's

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[6] The government asserts that after his discussion with Tinkham, respondent accumulated additional Pillsbury call options. (Govt. Br. at 5). This statement is misleading in its implication that respondent acted to acquire Pillsbury options on the basis of information provided him by Tinkham. In fact, the orders for the Pillsbury options had been placed by respondent *prior* to the alleged August 26, 1988 discussion with Tinkham. (*See* JA 214). Although respondent's orders, which were below-the-market limit orders, were not executed by his broker until late August or early September, he began ordering significant blocks of options on August 18 and had placed most of his orders for both options and stock on or before August 25. (*See* JA 39-54, 173-77). As the government admitted below, even under its theory of the case trades prior to August 26, 1988, could not be illegal because respondent had no inside information prior to that date. (JA 58-59). Because the essential inquiry in this case is whether respondent traded in securities *on the basis of* material, nonpublic information, moreover, the relevant operative act is the date on which respondent placed his orders for securities, *not* the date on which the orders were filled by respondent's brokers. The government failed to appreciate this distinction before the district court, asserting in a brief submitted to the court that "neither the defendant's decision to violate the law through the placement of orders for Pillsbury securities, nor his act of placing orders for those securities, amounts to a transgression of Section 10(b). Rather, *the actual purchases of securities* on O'Hagan's behalf ... serves as the conduct which amounts to a violation of Section 10(b) and Section 14(e)." (Govt. Resp. to Defendant's Mtn. Dismiss, April 9, 1993, at 33-34 (emphasis added)).

In its brief to the court of appeals, the government essentially conceded the Achilles heel of its argument -- that respondent traded *on the basis of* misappropriated material information -- when it admitted that respondent placed the orders for the Pillsbury securities in question *prior* to the conversation with Tinkham: "Although Tinkham had no way of knowing, O'Hagan *had set* himself on a course of accumulating an exceptional number of Pillsbury securities." (Govt. Ct. of App. Br. 9 (emphasis added)).

In its Petition for Certiorari, the government suggested that it is significant that, after his discussion with Tinkham, respondent shifted from purchasing Pillsbury call options with September expiration dates to purchasing options

purchase of Pillsbury securities had no impact on the price of Pillsbury shares, as the government concedes. (*See* Govt. Br. at 3).

At the time of the Tinkham/O'Hagan conversation, Grand Met's designs on Pillsbury were no secret. On August 18, 1988, the well-known financial columnist Dan Dorfman ("Dorfman") announced on Cable News Network ("CNN") that "people close to Grand Metropolitan ... are telling people in the street that Grand Metropolitan is interested in acquiring Pillsbury." (JA 78-80).[7] On August 12, 1988, the Wall Street Journal reported that Grand Met had put its hotel chain up for auction to raise money for an acquisition and, on August 22, 1988, Investment Dealers Digest announced that Grand Met was selling its hotel chain in order to buy Pillsbury. (Govt. Ex. 57; JA 73-74).

It was against this backdrop that the discussion between Tinkham and respondent took place. Tinkham testified that the discussion, lasting no more than five minutes, occurred as he was preparing to meet with partners from the law firm's corporate department to discuss whether the firm should represent Grand Met in its efforts to take over a local company. According to Tinkham, as he was preparing for the meeting, respondent stopped by his office. Respondent told Tinkham that he understood that Tinkham was working on a takeover of the Pillsbury Company and suggested he would be interested in working on the matter, noting that he "hated the Pillsbury Company" based on prior business dealings.[8] (JA 129; *see generally* Appendix to Respondent's Opposition to Certiorari (Tinkham transcript)). Tinkham declined respondent's offer to work on the case. Tinkham mentioned,

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with later expiration dates. (Govt. Pet. at 5). But the only pertinent evidence on this point confirms that the options with later expiration dates were purchased to fill orders placed prior to August 26, and that the change in the expiration dates occurred at the suggestion of respondent's broker. (*See* JA 176-77).

[7] The government's expert, Michael Kennedy, testified that Dorfman's information probably came from Grand Met insiders (JA 79-80).

[8] Although the government now asserts that respondent "feigned an interest in working on litigation involving the Pillsbury takeover," (Govt. Br. at 20), nothing in the record supports this characterization.

however, that he was going to meet with the partners from the corporate group. Tinkham testified that this led to a short discussion "about a general policy relating to [the firm's] non-involvement in hostile takeovers of local companies." (JA 132).

During trial, the government asserted repeatedly that respondent learned from his law firm of *Grand Met's* plans to acquire Pillsbury. (*See, e.g.*, JA 189). Indeed, in its Petition for Certiorari to this Court, the government asserted that "[a]lthough Tinkham declined respondent's offer to work on the case, *Tinkham discussed Grand Met's plans to acquire Pillsbury's common stock with respondent.*" (Govt. Pet. at 4 (emphasis added)). This assertion misstates the undisputed record as to what respondent actually learned from Tinkham. Construing the evidence in the light most favorable to the government, the most that can be said is that respondent's conversation *confirmed* something the government asserts respondent already knew: that Dorsey had been retained to represent an *undisclosed* client in connection with a *possible* takeover of Pillsbury.[9] As the district court found, respondent did *not* learn that the Dorsey client was Grand Met. (*See* JA 132).[10] Moreover, respondent did not learn - and could

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[9] The government has never contended, and did not contend at trial, that the fact that Dorsey had been retained in connection with a possible takeover of Pillsbury was itself material information sufficient to sustain a securities fraud claim. Instead, the government has always emphasized that respondent had knowledge of something more; specifically, Grand Met's "secret plan." Nothing in the record of this case would support a finding that Dorsey's retention was material information and, indeed, the trial court prevented respondent from offering expert testimony that there was nothing material about the information that the Dorsey firm had been retained by someone in connection with a possible takeover of Pillsbury. (Tr. Vol. XI, pp. 29-30).

[10] In denying respondent's motion to dismiss the indictment, the district court found that "an essential element of the offenses" with which respondent was charged was the government's allegation in paragraph 14 of the indictment that respondent "learned his firm was retained *by Grand Met* to represent them in connection with a tender offer *and then* purchased Pillsbury stock and call options..." (Magistrate's Report (September 10, 1993) at 14-15 (emphasis added)). There is no evidence to support this "essential element" of the government's case. After the government rested, the district court

not have learned -- any details of any takeover plan. At the time of the Tinkham/O'Hagan conversation, the details of Grand Met's takeover plan had not been formulated.

The undisputed evidence shows that, although as of September 18, 1988, Grand Met had made a decision "in principle that [it] would like to acquire Pillsbury," even at that time, "*the decision to launch the hostile tender offer had not been taken.*" (JA 182-83 (emphasis added)). As explained by Paul S. Walsh, the then Chief Financial Officer of Grand Met and currently the Chief Executive Officer of Pillsbury, Grand Met could not pursue Pillsbury unless and until it sold its hotel subsidiary, Intercontinental Hotels ("ICH"), to fund the offer -- a transaction that was by no means a foregone conclusion at the time of the O'Hagan/Tinkham conversation. (JA 180-81).[11] The Grand Met board required a signed contract for the sale of the hotel subsidiary before any tender offer for Pillsbury could be considered. According to Walsh, "Had we not found a purchaser of our hotel division, we would have delayed the acquisition of Pillsbury until we found such a purchaser." (JA 181). Grand Met sold ICH on September 30, 1988, and Mr. Walsh himself did not "first learn that a tender offer indeed would be made for Pillsbury" until October 1, 1988. (JA 182). Thereafter, the Grand Met board met on October 3, 1988, and authorized a hostile tender offer for Pillsbury.

Thus, the record is unequivocal that on August 26, 1988, Grand Met had not made a decision to launch a hostile takeover of Pillsbury and, indeed, lacked the financial resources to commence the tender offer. The Dorsey firm withdrew from its representation

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acknowledged that the government had failed to prove this part of its case when the court stated: "[T]*he record says he didn't know it was Grand Met's information.*" (JA 167 (emphasis added)).

[11] An August 12, 1988 article in the Wall Street Journal reporting that Grand Met had put its hotel subsidiary up for auction to raise money for an acquisition noted that Grant Met was asking $2.5 billion for a company Grand Met had purchased for $600 million in 1986. Several experts were quoted in the article to the effect that the price was "outrageous" and would never be obtained. (Govt. Ex. 57).

of Grand Met on September 9, 1988, and did not represent Grand Met in the tender offer.[12]

Both before the district court and on appeal, respondent argued that the government had failed to produce evidence essential to support the charges included in the indictment, including specifically any evidence that respondent had purchased securities on the basis of "material, nonpublic" information. Respondent also challenged the legal theories under which he was indicted, including those at issue before this Court.

On August 2, 1996, the court of appeals reversed respondent's convictions on all 57 counts of the indictment. *United States v. O'Hagan*, 92 F.3d 612 (8th Cir. 1996). The government's subsequent petition for rehearing and suggestion for rehearing en banc was denied on November 13, 1996, with only one judge voting to grant an en banc hearing.

The Opinion of the Court of Appeals

While not rejecting any of the eight grounds for reversal asserted by respondent, the court of appeals reversed respondent's conviction on all counts on the basis of three arguments. First, the court found that neither the statutory language of §10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §78j(b), nor Supreme Court precedent interpreting it, will support the use of the misappropriation theory, the theory which formed the basis for O'Hagan's §10(b) securities fraud convictions. Second, the court held that the Securities and Exchange Commission

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[12] The decision to withdraw was made by the Dorsey firm on September 9, 1988. (JA 108). Tinkham advised Cravath on September 11, 1988 of Dorsey's withdrawal. In his conversation with Cravath partner Charles Parker, Tinkham indicated that he had not realized until September 9 that the representation "would involve hostile litigation." (JA 108-09). Thus, the evidence establishes only that, as of August 26, 1988, Tinkham knew that Grand Met was interested in acquiring all of Pillsbury's stock at some unknown time in the future. (*See* JA 124-25 (Tinkham testimony), *see also* JA 180-83 (testimony of Pillsbury CEO Paul Walsh)). There is no evidence that Tinkham divulged even this fragmentary knowledge to respondent.

exceeded its rulemaking authority under §14(e) of the Exchange Act, 15 U.S.C. §78n(e), when it promulgated Rule 14e-3(a), 17 C.F.R. §240.14e-3(a), and omitted therefrom the requirement that a breach of a fiduciary duty be shown in order to violate the rule. Finally, because the mail fraud counts were structured in the O'Hagan indictment so as to hinge on the validity of the securities fraud counts, the court vacated these counts as well. Judge Fagg wrote a single paragraph in dissent in which he acknowledged that the majority's opinion was "carefully analyzed" and "well reasoned," but disagreed with its result. 92 F.3d at 628.

SUMMARY OF ARGUMENT

This is a criminal case controlled by two fundamental principles of law. First, an administrative agency's interpretation of a statute under which it has been given rule-making authority is limited by the language of the statute itself; an administrative rule that exceeds its statutory mandate is invalid. *See Central Bank, N.A. v. First Interstate Bank, N.A.* 511 U.S. 164 (1994). Second, those accused of criminal conduct are entitled to meaningful notice of the law. *Hynes v. Oradell*, 425 U.S. 610 (1976); *Buckley v. Valeo*, 424 U.S. 1 (1976). Penal statutes must be written in language that to the "common world" is clear and definite so as to insure that no individual is convicted unless a fair warning has first been given of what the law intends to do if a certain line is passed. *Babbitt v. Sweet Home Chapter of Communities for a Great Or.*, __U.S.__, 115 S.Ct. 2407 (1995); *Mourning v. Family Publications Serv., Inc.*, 411 U.S. 356 (1973). Respondent's conviction in this case contravened both of these settled principles of law and, accordingly, the Eighth Circuit Court of Appeals acted properly in reversing the conviction.

A. Misappropriation Theory

In the context of this case, the touchstone of liability under §10(b) is a finding of deception "in connection with the purchase or sale of a security." The misappropriation theory, under which

respondent was convicted, does not require "deception," but instead "permits the imposition of §10(b) liability based upon the mere breach of a fiduciary duty without a particularized showing of misrepresentation or nondisclosure." *O'Hagan*, 92 F.3d at 618. This result contravenes the holdings of *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977), and *Central Bank*, which established that the mere breach of a fiduciary obligation, without misrepresentation or nondisclosure, is not deception within the meaning of §10(b).

In addition, although the language of §10(b) requires that the fraud alleged be "in connection with the purchase or sale of any security," the misappropriation theory renders this requirement nugatory, permitting liability for a breach of duty owed to individuals who are unconnected with a securities transaction. This result is inconsistent with *Chiarella v. United States*, 445 U.S. 222 (1980), *Dirks v. SEC*, 463 U.S. 646 (1983), and *Central Bank*, which limit liability under §10(b) to situations involving a breach of duty to participants in a securities transaction.

Contrary to the government's argument, whether the misappropriation theory is necessary to combat securities fraud, and should therefore be enacted as law, is a determination for Congress, not the courts, to make. In the words of this Court, "[t]he issue [here presented] is not whether imposing ... liability ... is good policy but whether [it] is covered by the statute." *Central Bank*, 114 S.Ct. at 1448; *see Dunn v. Commodity Futures Trading Comm'n*, __U.S.__, 117 S.Ct. 913, [illegible] (1997) (argument that "options are particularly susceptible to fraud and abuse if not carefully policed" was one "best addressed to the Congress, not the courts"). Similarly irrelevant is the argument of the government and certain amici that statements in the legislative history of the 1984 and 1988 amendments to the securities laws, none of which dealt specifically with the statutory provisions here at issue, indicate Congressional approval of the misappropriation theory. "Congress may legislate ... only through passage of a bill which is approved by both Houses and signed by the President." *Central Bank*, 114 S.Ct. at 1453. Congress has not amended §10(b) to codify the misappropriation theory. Isolated statements by

members of a subsequent Congress as to the meaning of a statute enacted by an earlier Congress are, at best, legislative dicta, *Dunn*, 117 S.Ct. at 919-20, and, therefore, are not determinative of any issue in this case.

At the time of the alleged conduct here at issue, no statute creating a cause of action for misappropriation had been enacted. Even if this Court were to conclude that an argument for implying such a cause of action in §10(b) could be made, there is sufficient uncertainty concerning both the statutory authorization for the theory and its parameters to avoid, for purposes of due process, its application in a criminal context. *See Grayned v. City of Rockford*, 408 U.S. 104, 108 (1972).

B. Rule 14e-3(a)

The SEC exceeded its rulemaking authority in promulgating Rule 14e-3(a) without including a requirement of a breach of fiduciary duty. Rule 14e-3's enabling statute, §14(e) of the Exchange Act, makes it unlawful for any person to engage in any "fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer." This Court has held that a failure to disclose material nonpublic information is "fraudulent" (the relevant term at issue), only when "one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them." *Chiarella*, 445 U.S. at 228 (quoting *Restatement (Second) of Torts* §551(2)(a)). Accordingly, the term "fraudulent" under §14(e) requires a breach of fiduciary duty.

Contrary to the government's position, the rulemaking provision of §14(e) does not authorize the SEC to redefine common law fraud. The enabling provision of the statute simply permits the SEC to define "such acts and practices *as are fraudulent*." This Court explicitly rejected the government's argument in *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985), with regard to the term "manipulative," stating that the rulemaking provision authorized the SEC to prevent manipulative acts "without suggesting any change in the meaning of the term 'manipulative'

itself." *Id.* at 11 n.11. Neither the text nor the legislative history of §14(e) provides the "explicit evidence of congressional intent" required for such a dramatic departure of established law, *Chiarella*, 445 U.S. at 233, and any ambiguity should be resolved in favor of lenity.

Rule 14e-3 also improperly extends §14(e) to prohibit trading in advance of a tender offer if "substantial steps" have been commenced toward that offer. The plain language of §14(e) prohibits fraudulent acts "in connection with a tender offer," and the "sole purpose" of the Williams Act was "the protection of investors who are confronted with a tender offer." *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 35 (1977). The SEC's expansion of §14(e) is unreasonable, as it fails to comport with due process on two levels. First, Rule 14e-3 does not define "substantial steps" and thus fails to give fair notice as to when, in advance of an offer, the violation occurs. Second, Rule 14e-3 does not require that the defendant have knowledge of the triggering "substantial steps." An individual may now be imprisoned under §14(e) for trading in advance of a tender offer without any knowledge of any offer. The statute, as well as due process, requires more.

C. Mail Fraud Counts

The court of appeals reversed respondent's mail fraud convictions because "the indictment was structured in such a manner as to premise the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud." 92 F.3d at 627.[13] This holding was correct because respondent's indictment specifically uses the statutory language of §10(b) as an element of mail fraud, as it charges that the "scheme to defraud" element of mail fraud is a scheme "in connection with the purchase and sale of securities." The court was careful to point out that it was *not* holding, as a matter of law, that where both mail fraud and

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[13] Judge Fagg, in dissent, did not disagree with the court of appeals' finding. He simply noted that, since he would uphold the securities fraud convictions, he found no basis to reverse the conviction for mail fraud. 92 F.3d at 628.

securities fraud counts are brought, they are necessarily interdependent so that the dismissal of one requires the dismissal of the other. *Id.* ("The mere fact that O'Hagan's securities convictions have been reversed does not as a matter of law require that the mail fraud convictions likewise be reversed.") Therefore, the conflict which the government seeks to create between this case and *Carpenter v. United States*, 484 U.S. 19 (1987), is illusory. The decision of the court of appeals, accordingly, should be affirmed.

ARGUMENT

I. THE MISAPPROPRIATION THEORY IS AN INVALID EXTENSION OF §10(b)

The government indicted respondent for securities fraud in violation of §10(b) of the Exchange Act and Rule 10b-5 promulgated pursuant thereto. Section 10(b) prohibits the use:

> in connection with the purchase or sale of any security [of] ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe ... in the public interest or for the protection of investors.

In 1942, acting pursuant to the authority granted to it under §10(b), the SEC promulgated Rule 10b-5 which provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, * * *
>
> (a) [t]o employ any device, scheme, or artifice to defraud, [or] * * *
>
> (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. §240.10b-5.

Rule 10b-5 has been described by this Court as a "judicial oak which has grown from little more than a legislative acorn." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975). By imposing *criminal* liability under Rule 10b-5 via the SEC-invented "misappropriation theory," the government asks this Court to remake a "judicial oak" into a prosecutorial Tyburn tree.

In 1961, almost 30 years after §10(b) was enacted and 19 years after Rule 10b-5 was promulgated, the SEC thought up a theory of liability under Rule 10b-5 that it called "insider trading." *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). The theory initially evolved into what has now been characterized as the "classical theory" of insider trading, where a person violates Rule 10b-5 "when he or she at the same time is an insider of the corporation whose securities are traded." *O'Hagan*, 92 F.3d at 616 (quoting *SEC v. Cherif*, 933 F.2d 403, 408 (7th Cir. 1991)). The government's first attempt to expand its theory of "insider trading" to reach "outsiders" was rejected by this Court in *Chiarella*, *infra*. Not satisfied with *Chiarella's* limitations, however, the government invented the "misappropriation theory" to reach the conduct of "outsiders" who owe no fiduciary duty to the shareholders of the company whose securities are traded, but owe a duty to the outside "source" of the information.

In derogation of the "classical theory," the "misappropriation theory" jettisons the statutory requirement of deception in connection with the purchase or sale of a security in a misplaced attempt to "fill a gap" in the law. (Govt. Cert. Pet. at 12). Because it rests upon no statutory foundation, this "theory" has become increasingly unclear. Now rejected by both the Fourth and the Eighth Circuits, the theory has been the subject of uncertainty and confusion even in those circuits which have adopted it.[14] *See SEC*

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[14] The amicus briefs filed in this case in support of the government only underscore the ambiguity inherent in the misappropriation theory. In its brief amicus curiae, the American Institute of Certified Public Accountants argues the need for a "coherent interpretation of the statutory language that can be applied by the lower courts." (Br. at 2). Another of the amici, the Association for Investment Management and Research, urges the Court to "clarify" the misappropriation theory, arguing that a clearly defined misappropriation theory will give guidance and protection to investment analysts and market participants generally and that "uncertainty concerning the scope of the

v. Lenfest, 949 F.Supp. 341, 343-44 (E.D. Pa. 1996) (noting differences in the formulation of the misappropriation theory between the Seventh and Ninth Circuits). The inconsistency in the theory's application within the Second Circuit, from which it originated, led one court to comment that the theory's "harrowing evolution [is] almost a testament to the theory's invalidity." *United States v. Bryan*, 58 F.3d 933, 953 (4th Cir. 1995).

In short, neither the language of §10(b) nor the decisions of this Court interpreting §10(b) and Rule 10b-5 support the misappropriation theory, as applied in this case. Even if this Court were to conclude that the theory can be reconciled with the text of §10(b), moreover, the confusion surrounding the scope of the theory and the uncertainty concerning its statutory authorization preclude the application of the theory, consistent with due process, in a criminal context.

A. The Misappropriation Theory Is Not Encompassed Within The Text Of §10(b), Nor Can It be Reconciled With This Court's Interpretations Of The Statute.

"'The starting point in every case involving construction of a statute is the language [of the statute] itself.'" *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975)); *see also Central Bank*, 114 S.Ct. at 1446 ("It is inconsistent with settled methodology in §10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text.").[15] The touchstone of

misappropriation theory" currently chills the free flow of information. (Br. at 11-12).

[15] In *Central Bank*, this Court refused to extend §10(b) to cover aider and abettor liability, despite the fact that "[i]n *hundreds* of judicial and administrative proceeding in every circuit in the federal system, the courts and the SEC have concluded that aiders and abettors are subject to liability under §10(b) and Rule 10b-5." 114 S.Ct. at 1456 (Stevens, J., dissenting). There is no similar consensus among the courts as to either the parameters of the misappropriation theory or its inclusion in §10(b). *See* discussion at 28-29, *infra*.

liability under §10(b) is the existence of "manipulation" or "deception" "in connection with the purchase or sale of any security." *See Santa Fe*, 430 U.S. at 473 ("The language of §10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception."). "Manipulation" is "virtually a term of art" in the securities context, referring "generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity," *id.* at 476, and has no relevance to the facts of this case, or an assessment of the misappropriation theory. The validity of the misappropriation theory, as applied in this case, then, turns on the meaning of the statutory phrase "deceptive device" "in connection with the purchase or sale of a security."[16]

1. The misappropriation theory does not require deception within the meaning of §10(b), but instead turns on a showing of a conversion in breach of a fiduciary duty.

As this Court noted in *Chiarella*, "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud." 445 U.S. at 234-35. More specifically, §10(b) catches a particular kind of fraud -- deception. Deception or deceit has a specific legal meaning. As defined by the *Restatement (Second) of Torts*, deceit involves a fraudulent misrepresentation or a failure to disclose where there is a duty to disclose which induces another person to act to his detriment or to refrain from acting in reliance upon the misrepresentation or omission. *See Restatement* §§525,

[16] In contrast to §10(b), Rule 10b-5 prohibits "fraud" in describing the deception proscribed under §10(b). 17 C.F.R. §240.10b-5. However, "fraud under Rule 10b-5 cannot be construed more broadly than its statutory enabler, deception; in other words, Rule 10b-5 fraud cannot prohibit conduct that does not amount to §10(b) deception." *O'Hagan*, 92 F.3d at 615. *See also Ernst & Ernst*, 425 U.S. at 214 (SEC's authority does not extend beyond the scope of power granted it by Congress under §10(b)).

551.[17] Consistent with this definition of deceit, this Court has consistently defined the type of conduct encompassed within §10(b) to require a misrepresentation or an omission where there is a duty to disclose. Thus, in *Santa Fe*, the Court rejected the Second Circuit's position that "neither misrepresentation nor nondisclosure [is] a necessary element of a Rule 10b-5 action," and held that the "deception" proscribed by §10(b) is the making of a material misrepresentation or the nondisclosure of material information in violation of a duty to disclose. 430 U.S. at 470. More recently, in *Central Bank*, 114 S.Ct. at 1448, the Court reaffirmed that: "As in earlier cases considering conduct prohibited by §10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act."[18]

The essence of the misappropriation theory -- as used by the government in this case and elsewhere -- is not deception, but a breach of a fiduciary duty by one who misuses or converts nonpublic information entrusted to him by another in confidence for personal gain. As stated by the government, "[u]nder the misappropriation theory of insider trading, a person commits fraud on the source of information for securities trading when he *uses* confidential information for his trading in a *breach of a fiduciary or similar duty owed to the source*." (Govt. Br. at 14 (emphasis added)). It is the "trading on converted confidential information" that, in the government's view, "implicates Section 10(b)'s protections against fraud in connection with securities trading." (*Id.* at 15). As applied by the government in this case and others, "theft rather than fraud or deceit, seems the gravamen of the [misappropriation] prohibition." *United States v. Chestman*, 947

[17] "Deceit" was similarly defined at the time of §10(b)'s enactment. *See Restatement of Torts* §§525, 531 (1938); *Black's Law Dictionary* 336, 522 (2d ed. 1910) (definitions of "deceit" and "fraudulent misrepresentation").

[18] The government's suggestion that a meaningful distinction can be drawn between deception in general and §10(b)'s reference to a "deceptive device" ignores the fact that, whatever a "deceptive device" is, it must necessarily entail deception.

F.2d 551, 578 (2d Cir. 1991) (Winter, J., concurring in part and dissenting in part).

In an attempt to fit the misappropriation theory within the confines of §10(b), the government contends that conversion by an agent of confidential information entrusted to him by his principal is a "well recognized species of fraud," citing this Court's decision in *Carpenter*. The government asserts that "[s]ince 'it is impossible for a person to embezzle the [property] of another without committing a fraud upon him,' ... misappropriation may be considered, as it was in *Carpenter*, a 'garden variety' type of fraud." (Govt. Br. at 17 (citations omitted)). Deception, as defined by this Court for purposes of §10(b), however, is not a "garden variety" type of fraud. It is a very specific type of fraud, which is dependent upon a showing of a misrepresentation or nondisclosure in violation of a duty to speak which induces another to act or to refrain from acting to his detriment.[19]

The government urges this Court to collapse the separate torts of misappropriation (or conversion) and deception into one for purposes of §10(b) by holding that the tort of deception is necessarily inherent in any misappropriation of confidential information by one standing in a fiduciary relationship to the owner of the information. In the government's words, "[c]onversion of confidential information by its very nature involves deception." (Govt. Br. at 19). The government transmutes conversion into deception by implying into an agent's dealings with his principal a continuing representation that the agent is honest and loyal to the principal's interests. Under the government's theory, the

[19] *Carpenter* was decided, not under §10(b), but under the mail fraud statute which predicates liability on the establishment of a "scheme to *defraud*" rather than deception. As the court of appeals noted below, this Court has refused to import into §10(b) all concepts of fraud appearing in other federal statutes. *O'Hagan*, 92 F.3d at 621 (citing *Santa Fe*, 430 U.S. at 471-72). While the misappropriation alleged in *Carpenter* and the embezzlement in *Grin v. Shine*, 187 U.S. 181, 189 (1902), cited in *Carpenter*, may constitute examples of "a garden variety" of fraud, conversion and embezzlement are not synonymous with deception because they do not require misrepresentation, nondisclosure, or inducement. *Carpenter*, then, is not dispositive of this case.

nondisclosure of the breach is a deception because the breach necessarily renders untruthful the agent's implicit continuing representation of loyalty.[20]

In *Santa Fe*, however, this Court specifically rejected the view of the Second Circuit that "neither misrepresentation nor nondisclosure [is] a necessary element of a Rule 10b-5 action" and that a breach of fiduciary duty, in and of itself violates §10(b). 430 U.S. at 470. In the Court's words:

> To the extent that the Court of Appeals would rely on the use of the term "fraud" in Rule 10b-5 to bring within the ambit of the Rule all breaches of fiduciary duty in connection with a securities transaction, its interpretation would, like the interpretation rejected by the Court in *Ernst & Ernst*, "add a gloss to the operative language of the statute quite different from its commonly accepted meaning."

430 U.S. at 472. In *Central Bank*, the Court reiterated that §10(b) does not "reach[] breaches of fiduciary duty ... without any charge of misrepresentation or lack of disclosure." 114 S.Ct. at 1446.[21]

The government argues that because *Santa Fe* involved "a transaction in which all material facts were fully disclosed," it does not "create doubt that misappropriation in breach of a fiduciary or similar duty is 'deceptive.'" (Govt. Br. at 19). Under the theory posited by the government in this case, however, there *was*

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[20] As noted by Professor Coffee, one of the government's amici in this case, in commenting on the "fiduciary breach" theory of mail fraud: "[T]he protean character of the term 'fiduciary' has enabled the prosecutor to reach areas that *Congress never contemplated would be subject to federal criminal sanctions*." John C. Coffee, *The Metastasis of Mail Fraud: The Continuing Story of the "Evolution" of a White-Collar Crime*, 21 Am. Crim. L. Rev. 1, 1-2 (1983) (emphasis added).

[21] In *Dirks*, the Court confirmed that the position stated by the Court in *Santa Fe* and *Central Bank* also applied in criminal and enforcement actions under §10(b): "Not 'all breaches of fiduciary duty in connection with a securities transaction' ... come within the ambit of Rule 10b-5. There must also be 'manipulation or deception.'" 463 U.S. at 654.

deception in *Santa Fe*. The majority shareholders in *Santa Fe* had a fiduciary duty to the minority shareholders which was breached. Consistent with the argument advanced by the government here, that breach necessarily entailed deception because the majority shareholders impliedly misrepresented to the minority shareholders that they were acting honestly and in the best interests of the business. Had the Court in *Santa Fe* agreed with the government's contention that a breach of fiduciary duty necessarily entails deception, it would *not* have found in *Santa Fe* that there had been full disclosure. The breach alone would have established the requisite misrepresentation.

In stating that a breach of fiduciary duty without misrepresentation or nondisclosure does not constitute deception for purposes of §10(b), then, this Court in *Santa Fe* must have rejected the contention that deception can be founded upon the implied misrepresentation which the government posits is inherent in every breach of fiduciary duty, including the breach of fiduciary duty in *Santa Fe*.[22] At the very least, because deception involves inducing another to act to his detriment, a breach of fiduciary duty, in order to constitute deception, would have to be shown to have induced action on the part of another. In *Santa Fe*, the majority shareholders' breach of fiduciary duty to the minority shareholders did not induce the minority shareholders to act to their detriment since they were provided with all material information necessary to their decisionmaking. Similarly, in this case, respondent's alleged

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[22] As Professor Coffee has noted, there are "troubling consequences" inherent in criminalizing fiduciary breaches, including specifically the fact that "significant differences exist among state jurisdictions in terms of the duties that fiduciaries owe, thereby possibly creating significant disparities in the coverage of federal criminal law depending on the applicable civil law." John C. Coffee, *From Tort to Crime: Some Reflections on the Criminalization of Fiduciary Breaches and the Problematic Line Between Law and Ethics*, 19 Am. Crim. L. Rev. 117, 150 (1981). Absent a clear mandate of Congress authorizing the criminalization of breaches of duties defined by such things as workplace rules and professional codes of responsibility, the courts may not federalize breaches historically left to the states to punish.

breach of fiduciary duty cannot be said to have induced Grand Met or Dorsey to act or refrain from acting to its detriment.

The government has suggested that the misappropriation theory can be reconciled with §10(b)'s requirement of deception because "misappropriation will often involve overt lies," citing as one example, respondent's "feign[ing] an interest in working on litigation involving the Pillsbury takeover." (Govt. Br. at 21). This reference to "feigned interest" is a semantic artifice of appellate counsel used to suggest an aura of "deception" when the record is devoid of any such evidence and this was never argued below. Nor was it ever suggested below that respondent's alleged "feigned interest" induced Tinkham (or Grand Met) into doing, or refraining from doing, anything. Tinkham dismissed out of hand respondent's interest in working on any Pillsbury litigation. (JA 130). According to Tinkham, he disclosed to respondent that Dorsey was representing an unnamed client in connection with a possible acquisition of Pillsbury simply because, as a partner, respondent was entitled to the information. (JA 131). It is, thus, not the fact that respondent was able to *obtain* information about Dorsey's representation of an unnamed entity in connection with a possible acquisition of Pillsbury about which the government complains; rather, it is his *use* of the information -- *i.e.*, the misappropriation or conversion of that information in breach of a fiduciary duty -- which is the gist of the alleged crime.

Assuming arguendo that the facts in this case could support a finding of deception within the meaning of §10(b), however, the government still could not prevail, because the indictment did not charge respondent with deception, and the jury was not instructed that it had to find deception to return a verdict against respondent for securities fraud. The indictment charges that respondent:

> engaged in a scheme and artifice to defraud Grand Met and Dorsey and Whitney in connection with the purchase and sale of securities *by purchasing* Pillsbury common stock and call options on Pillsbury common stock *while in the possession* of material, non-public information concerning Grand Met's future tender offer for Pillsbury common stock.

Indictment, Description of Scheme to Defraud ¶2 (JA 8 (emphasis added)). Nothing in this paragraph, or elsewhere in the indictment, alleges that respondent ever misrepresented anything or failed to disclose to his law firm anything he was under a duty to disclose. Specifically, contrary to the government's brief, the indictment does not charge respondent with having "feigned" interest in the Pillsbury litigation or of having done anything else that induced either Grand Met or Dorsey to act to its detriment. Instead, the securities fraud charged in the indictment is that respondent breached his fiduciary duty to Grand Met and Dorsey by "misappropriat[ing] the information relating to Grand Met's future tender offer for Pillsbury common stock and purchas[ing] Pillsbury common stock and call options on Pillsbury common stock." (JA 16 ¶3). *See also id.* ¶4 (charging that respondent "did use and employ manipulative and deceptive devices and contrivances" by "purchasing" Pillsbury securities). The indictment charges breach of fiduciary duty and conversion. It does not charge deception, *i.e.*, misrepresentation or nondisclosure as defined by this Court for purposes of §10(b).

The instructions given to the jury echoed the claims in the indictment. (JA 194).[23] While the instructions charged that respondent must have acted "with the intent to defraud," nowhere do they tell the jury what deception under §10(b) and Rule 10b-5 means. (*See* JA 195-96).[24] Essentially, the jury was instructed that

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[23] With respect to the counts alleging violation of §10(b), the jury was instructed:

> In Counts 21 through 37, it is claimed that O'Hagan used the information which came to him to work a fraud on Grand Met and Dorsey and Whitney. Now, according to the indictment, he worked this fraud *by purchasing* Pillsbury stock and options *while he was in possession of* material, nonpublic information concerning Grand Met's upcoming tender offer for Pillsbury securities. (JA 194).

[24] The jury was charged that it had to find that respondent had "misappropriated" material, nonpublic information. "Misappropriation" was

it could convict respondent under §10(b) and Rule 10b-5 if it found that he had breached a fiduciary duty to Grand Met or Dorsey by trading in Pillsbury securities while in possession of nonpublic information obtained from either of them. The district court's instructions, like the indictment itself, are defective because they failed to include the separate element of deception as defined in *Santa Fe*, *Dirks*, and *Central Bank*. A conviction cannot be upheld on the basis of a legal theory reflected in neither the indictment nor the jury charge. *See Rewis v. United States*, 401 U.S. 808, 814 (1971).

2. The misappropriation theory does not satisfy the "in connection with" requirement of §10(b).

Section 10(b) makes it unlawful to "use or employ, in connection with the purchase or sale of any security" "any manipulative or deceptive device or contrivance." There is no evidence in this case that respondent used deception in[25] the purchase or sale of any security. Respondent made no representations to the Pillsbury shareholders whose shares he purchased. Because he owed no fiduciary duty to Pillsbury shareholders, he had no duty to disclose the information he allegedly had regarding an unknown client's interest in Pillsbury.

The government contends, however, that it can satisfy the "in connection with" requirement by proving that respondent breached a fiduciary duty to the outside source of the information and, thereafter, used the fruits of that breach to purchase securities. In permitting liability to be premised on a showing of "fraud on the source" instead of fraud on a person involved in the purchase or sale of securities, the misappropriation theory transforms §10(b)

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never defined by the court to require deception. Indeed, the jury was instructed that they could find deception if they found that respondent had used material information which he knew was given to him in confidence. (*See* JA 200 (defining intent to deceive, manipulate, or defraud)).

[25] This Court has, on other occasions, suggested that "in" is a reasonable substitute for phrases such as "in regard to" or "in connection with." *See Dunn*, 117 S.Ct at 916; *United States v. Naftalin*, 441 U.S. 768, 773 & n.4.

from a statute focused on the relation between parties to a securities transaction into one which "permits liability for a breach of duty owed to individuals who are unconnected to and perhaps uninterested in [the] transaction." *O'Hagan*, 92 F.3d at 618. Analytically, the flaw in the misappropriation theory is clear: the theory "artificially divides into two discrete requirements -- a fiduciary breach and a purchase or sale of securities -- the single indivisible requirement of deception upon the purchaser or seller of securities, or upon some other person intimately linked with or affected by a securities transaction." *Bryan*, 58 F.3d at 950.[26] In so doing:

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[26] The government has suggested that Grand Met fits within the category of persons referred to in *Bryan* as those "intimately linked with or affected by a securities transaction." That this is not the case is clear from language elsewhere in *Bryan*. The *Bryan* court described what it meant by persons "closely linked to a securities transaction" by reference to *Blue Chip Stamps*. 58 F.3d at 948. In *Blue Chip Stamps*, the Court had acknowledged that other persons beyond purchasers and sellers may be damaged by violations of Rule 10b-5. 421 U.S. at 743. As noted in *Bryan*, however, the *Blue Chip Stamps* Court included in this category "potential purchasers of shares" and "actual shareholders" ***"who decide not to purchase or sell due to material misrepresentations or omissions"*** and "shareholders, creditors, and perhaps others related to an issuer who suffered loss in the value of their investment due to corporate or insider activities." *Id.* at 737-38 (emphasis added). The *Bryan* court also noted the protection afforded by §17(a) of the 1934 Act to "financial intermediaries such as stockbrokers, because their welfare is 'inextricably linked' to that of investors." 58 F.3d at 948. Grand Met does not fit within the class of investors or those acting as agents for investors referenced by *Bryan*. Any argument that the court intended by its reference to persons "affected by a securities transaction" to include within the class of persons protected by §10(b) those contemplating a future tender offer is defeated by the court's unequivocal assertion that "Section 10(b) is not concerned with the general fairness of securities transactions themselves, so long as there is no evidence of deception in connection with a securities transaction, in the form of material misrepresentations or omissions made to persons connected with a securities transaction." *Id.* at 952.

The analysis in *Bryan* of persons protected by §10(b) is consistent with the requirement that deception involve the inducement of action or inaction; in this case, the inducement of action or inaction by someone -- be it a purchaser,

> the theory effectively eliminates the requirement that a person in some way connected to a securities transaction be deceived, allowing conviction not only where the "defrauded" person has no connection with a securities transaction, but where no investor or market participant has been deceived. In allowing the statute's unitary requirement to be satisfied by any fiduciary breach (whether or not it entails deceit) that is followed by a securities transaction (whether or not the breach is of a duty owed to a purchaser or seller of securities, or to another market participant), the misappropriation theory transforms section 10(b) from a rule intended to govern and protect relations among market participants who are owed duties under the securities laws into a federal common law governing and protecting any and all trust relationships.

Id.

In its attempt to transform §10(b) from a statute principally concerned with the protection of purchasers and sellers of securities, or other market participants,[27] into one which seeks to punish those who may have engaged in fraudulent conduct outside the securities market, the misappropriation theory broadens §10(b)

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seller, broker, or another investor -- "in connection with the purchase or sale of any security." Neither Dorsey nor Grand Met was a participant in respondent's securities transaction and neither was induced to do anything "in connection with" the purchase or sale of securities. The government's suggestion that Grand Met should be treated as a market participant because it was a "bidder" for Pillsbury and "poised to become a 'market participant,'" (Govt. Br. at 25), misstates the record. *See* pp. 5- 7, *supra*.

[27] The government cites *Naftalin* as evidence that this Court has, in the context of a statute not here at issue, construed fraud "in" a securities transaction to encompass more than fraud on investors. (Govt. Br. at 22-23). *Naftalin* provides no support for the government's contention that a breach of duty to someone *other than a participant in a securities transaction* can give rise to liability under §10(b), however, since, in *Naftalin*, the brokers who were allegedly deceived *were* participants in the securities transactions at issue. In this case, by contrast, neither Grand Met nor Dorsey was a participant in respondent's securities transactions.

beyond the plain language of the statute in a manner inconsistent with the decisions of this Court.

In *Santa Fe*, the Court refused an invitation to interpret the statute by reference to "business ethics." The Court rejected the argument that a breach of a fiduciary duty by the majority shareholders to deal fairly with minority shareholders was sufficient to establish liability under §10(b) absent any evidence of fraud in a securities transaction. 430 U.S. at 476-77. Later, in *Aaron v. SEC*, 446 U.S. 680 (1980), the Court declined the SEC's invitation to interpret §10(b) by considering the impact of the challenged conduct on investors. The Court reaffirmed that the touchstone of liability was not whether investors suffered losses as a result of any conduct by the defendant but whether the conduct was deceitful or fraudulent. *Id.* at 685. *See also Ernst & Ernst*, 425 U.S. at 197-99 (rejecting SEC's argument in amicus brief that the Court should predicate §10(b) liability on an "effects" oriented approach).

In *Chiarella*, the Court affirmed that it is the relation between the insider -- a fiduciary to the corporation -- and the corporation's shareholders that triggers the disclosure obligation. Noting that the common law did not recognize a duty to equalize information through disclosure absent a relationship of trust and confidence, the Court delineated the test for actionable fraudulent nondisclosure under §10(b):

> [A]dministrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud actionable under §10(b) despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure. But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence *between parties to a transaction*.

445 U.S. at 230 (emphasis added). *See also id.* at 227-28, 232-33.

Dirks reaffirmed the principle that "[a] duty [to disclose] arises from the relationship between parties ... and not merely from one's

ability to acquire information because of his position in the market." 463 U.S. at 657-58.[28] Finally, in *Central Bank*, the Court again emphasized that the focus of §10(b) is on fraud directed toward purchasers or sellers of securities, or, at most, other market participants, noting that: "the broad congressional purpose" behind §10(b) is "to protect investors from false and misleading practices that might injure them." 114 S.Ct. at 1446. Consistent with *Dirks* and *Central Bank*, "a violation [of §10(b)] may be found only where there is 'intentional or willful conduct designed to deceive or defraud *investors.*'" *Dirks*, 463 U.S. at 663, n.23 (emphasis added).

Taken together, *Central Bank*, *Chiarella*, *Dirks*, and *Santa Fe* hold that §10(b) challenges may be brought only with respect to conduct prohibited by the text of the statute; that the deception proscribed in §10(b) is the making of a material misrepresentation or the nondisclosure of material information in violation of a duty to disclose; and that the deception to which the statute is directed is deception intended to induce action or inaction by purchasers and sellers of securities, or other market participants, involved in a particular securities transaction.[29] *See Bryan*, 58 F.3d at 944.

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[28] Although the quoted excerpt from *Dirks* references only "parties" and not "parties to a securities transaction," the Court earlier in the opinion had clarified that the duty to disclose was meant to be determined in the transactional context: "We were explicit in *Chiarella* in saying that there can be no duty to disclose where the person who has traded on inside information 'was not [the corporation's] agent, ... was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.'" 463 U.S. at 654 (quoting *Chiarella*, 445 U.S. at 232).

[29] Those courts that have adopted the misappropriation theory have reconciled the theory with the statute's requirement that there be deception "'in connection with the purchase or sale' of any security," by relying on dicta in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12-15 (1971), for the proposition that the deception need only "touch" a securities transaction and need not be upon a party interested in the transaction. The Eighth Circuit exposed the weakness of this argument, however, when it:

> decline[d] to ascribe such broad meaning to this single passage from *Bankers Life*. Such a sweeping interpretation appears to be inconsistent with the Court's statement in the immediately previous paragraph of *Bankers Life* that "we read §10(b) to mean that Congress meant to bar deceptive devices and contrivances ***in the purchase or sale of securities***." More importantly, the victim of the fraud in *Bankers Life* was a seller of securities who was "injured as an investor." Finally, if this passage held the all-encompassing meaning the government attributes to it, then we cannot fathom how the defendants in the subsequent *Chiarella*, *Dirks*, and recently *Central Bank* cases escaped §10(b) liability because each engaged in acts that "touched" the securities transaction.

92 F.3d at 619-20 (internal citations omitted) (emphasis added).

[30] At common law, one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to disclose. *Restatement (Second) of Torts* §551.

The misappropriation theory cannot be reconciled with the language of §10(b) as interpreted by this Court. Nor, as noted in *Bryan*, can the theory be reconciled with the "principles that inform interpretation of the securities fraud provisions." 58 F.3d at 950. As this Court has stated, the securities industry in general, including specifically the field of securities transactions within §10(b), is "'an area that demands certainty and predictability,'" and "decisions 'made on an ad hoc basis, offering little predictive value' to those who provide services to participants in the securities business," are to be avoided. *Central Bank*, 114 S.Ct. at 1454 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)). The misappropriation theory eviscerates the predictability of §10(b) by ignoring the settled rule, grounded in common law,[30] that the duty to disclose in the context of a securities transaction arises from a fiduciary relationship between participants in a securities transaction. In its place, the government urges a "theory" that regulates the relationship of parties to a securities transaction based on conduct occurring wholly outside the relationship.

Moreover, the misappropriation theory is unprincipled in application. Whatever principled basis there might be under a parity-of-information theory for precluding *all* trading on the basis of unlawfully-obtained material, nonpublic information, there can be no principled basis for precluding trading on the basis of nonpublic information unlawfully obtained through a breach of

fiduciary duty but permitting such trading if the information is obtained through theft or some other unlawful conduct. Yet, that is exactly what the misappropriation theory does. The government seeks, in this case, to punish respondent for allegedly trading in securities on the basis of confidential information obtained in breach of a fiduciary duty to his law firm and its client. Had a burglar simply broken into Grand Met's home office and stolen the same information, however, he would not be liable under the misappropriation theory, because he would not even arguably have engaged in deception within the meaning of §10(b). Yet the result of the wrongful conduct, in both cases, would be precisely the same.

In abandoning the textual requirement that deception for purposes of §10(b) occur between parties to a securities transaction -- *i.e.*, "in connection with the purchase or sale of any security" -- the misappropriation theory slips its statutory tether and, thus unleashed, invites "'a shifting and highly fact-oriented disposition of the issue of who may [be liable for] a damages claim for violation of Rule 10b-5.'" *Central Bank*, 114 S.Ct. at 1454 (quoting *Blue Chip Stamps*, 421 U.S. at 755). *See also Chestman*, 947 F.2d at 567 ("[F]iduciary duties are circumscribed with some clarity in the context of shareholder relations but lack definition in other contexts."). Because it lacks textual foundation, the misappropriation theory has proven unpredictable and inconsistent in its application by the courts that have adopted it. *See Bryan*, 58 F.3d at 951-52 (describing the myriad fiduciary situations in which the misappropriation theory has been applied and noting that "[i]t would be difficult to overstate the uncertainty that has been introduced into the already uncertain law governing fraudulent securities transactions through adoption of the misappropriation theory, with its linchpin the breach of a fiduciary duty"); *O'Hagan*, 92 F.3d at 622 n.14 (describing, as the "paradigmatic example of the attenuated circumstances in which a §10(b) conviction based on the misappropriation theory has been obtained" the decision in *United States. v. Willis*, 737 F. Supp. 269 (S.D.N.Y.), involving the alleged breach of a physician-patient duty); Harold S.

Bloomenthal, et al. *Securities Law Handbook* 1179 (1997) (The misappropriation theory "as the basis for insider trading liability is a theory in search of a rationalization.").[31] In the words of *Bryan*, "[a]bsent clearly defined rules, investors find themselves the targets of ad hoc decisionmaking or pawns in an overall litigation strategy known only to the SEC." 58 F.3d at 951. Not only is such decisionmaking antithetical to the policy of predictability in the securities arena, but also for reasons set forth below, such decisionmaking, when it constitutes the basis for a *criminal* prosecution, violates principles of due process.

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[31] Other commentators have similarly criticized the misappropriation theory. *See, e.g.*, Alan R. Bromberg & Lewis D. Lowenfels, *Bromberg and Lowenfels on Securities Fraud & Commodities Fraud* (2d ed. 1994) §7.5 (513) at 7:241-42 (concluding that "[w]e think the misappropriation theory as a part of securities law defies common sense. ... It is a Rube Goldberg contraption for the lower courts and the SEC to find a roundabout violation when the Supreme Court has rejected a direct violation.... As securities law, the theory is foolish in enforcement actions and absurd in private actions."); Michael P. Kenny & Theresa D. Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)*, 59 Alb. L. Rev. 139 (1995) ("The misappropriation theory goes wrong because it is untethered to the words of the statute. Free of textual constraint, the theory has been applied to conduct that cannot credibly be considered fraud, much less fraud in a securities transaction."); Sean P. Leuba, *The Fourth Circuit Breaks Ranks in United States v. Bryan: Finally, a Repudiation of the Misappropriation Theory*, 53 Wash. & Lee L. Rev. 1143, 1208 (1996) ("[T]he misappropriation theory contradicts precedent, protects relationships instead of investors, requires the evaluation of vague concepts of fiduciary duties, and does not provide clear guidelines for prospective enforcement."); Milton V. Freeman, *The Insider Trading Sanctions Bill - A Neglected Opportunity*, 4 Pace L. Rev. 221, 228 (1984) (The author of this article, a co-draftsman of Rule 10b-5 in 1942 in his capacity as Assistant Solicitor of the SEC, observes that "The SEC is so accustomed to the use of Rule 10b-5 as a be-all and end-all that it has not adequately recognized that the problem it is facing [outsider trading] is of a different character, larger than can readily be managed within that narrow compass," and urges the adoption of specific legislation addressed to the problem of outsider trading.).

B. Criminal Convictions Under The Misappropriation Theory Violate Due Process Because An Uncodified "Theory" Cannot Provide Adequate Guidance As To What Conduct Is Illegal.

As is clear from the preceding section, the misappropriation theory cannot be supported by reference to the text of §10(b) and, for that reason alone, the court of appeals' decision should be upheld. Moreover, even if §10(b) *could* be construed broadly to encompass the misappropriation theory, the application of an undefined "theory" to respondent's conduct in this case would violate due process and transgress the doctrines of fair notice, lenity and strict construction, and, thus, such a construction should be avoided. *Edward J. DeBartolo Corp. v. Florida Gulf Coast Building & Constr. Trades Council*, 485 U.S. 568, 575 (1988) ("[W]here an otherwise acceptable construction of a statute would raise serious constitutional problems, the Court will construe the statute to avoid such problems unless such construction is plainly contrary to the intent of Congress."); *Ashwander v. TVA*, 297 U.S. 288, 348 (1936) (Brandeis, J., concurring).

It is axiomatic that "[d]ue process requires that a criminal statute provide adequate notice to a person of ordinary intelligence that his contemplated conduct is illegal, for 'no man shall be held criminally responsible for conduct which he could not reasonably understand to be proscribed.'" *Buckley*, 424 U.S. at 77 (quoting *United States v. Harriss*, 347 U.S. 612, 617 (1954)); *see also Kolender v. Lawson*, 461 U.S. 352, 357 (1983). As this Court stated in *Grayned, supra*: "because we assume that man is free to steer between lawful and unlawful conduct, we insist that laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited, so that he may act accordingly." 408 U.S. at 108; *see also United States v. Aguilar*, __ U.S. __, 115 S. Ct. 2357, 2362 (1995) ("We have traditionally exercised restraint in assessing the reach of a federal criminal statute, both out of deference to the prerogatives of the Congress, and out of concern that 'a fair warning should be given to the world in language that the common world will understand of what the law intends to do if

a certain line is passed.'") (citations omitted); *Chiarella*, 445 U.S. at 235 n.20 ("[A] judicial holding that certain undefined activities 'generally are prohibited' by §10(b) would raise questions whether either criminal or civil defendants would be given fair notice that they have engaged in illegal activity.").

The misappropriation theory offends due process because it lacks definiteness. Released from the statutory constraints which once restricted §10(b)'s reach to conduct involving participants in a securities transaction, the misappropriation theory now extends the statute to encompass any breach of fiduciary duty, the fruits of which can be shown, however tenuously, to have "touched" a subsequent securities transaction.[32] The protean nature of the misappropriation theory sows confusion as to what constitutes lawful conduct,[33] and invites ad hoc decisionmaking.

The SEC has indicated its preference for this kind of case-by-case approach and has discouraged efforts by Congress to provide a clear articulation of the parameters of §10(b) and insider trading.[34] However, ad hoc decisionmaking is the antithesis of the

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[32] The government's purported "clarification" of the contours of the misappropriation theory in its brief underscores the fact that the theory has heretofore lacked *any* defined boundaries. Even this attempt to define the boundaries of the misappropriation theory, however, is not adequate to give notice as to what conduct is covered under this version of the theory and what is not; as the government concedes in its brief, it still must define the reach of the newly formulated theory on a case-by-case basis. (*See* Govt. Br. at 24 n.13).

[33] *See* Brief of the Association for Investment Management and Research as *amicus curiae* in support of the government in this matter, stating that uncertainty over the scope of the misappropriation theory chills the free flow of information. *See also Bryan*, 58 F.3d at 951, in which Judge Luttig noted that:

> Thus far, the misappropriation theory has been invoked by federal prosecutors and securities regulators to regulate such diverse relationships as that between an employer and employee, between an employer and an employee's tippees, between a newspaper and its reporters, between an employer and a former employee, between a psychiatrist and his patient, between a husband and wife, between a father and son, and, as in [*Bryan*], between a government official and his constituency. (citations omitted).

[34] In 1984, the SEC testified *against* a bill introduced specifically as a codification of the misappropriation theory. As described by Senator D'Amato,

due process protection in criminal cases. *United States v. Kozminski*, 487 U.S. 931, 951 (1988) (the Constitution does not

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the bill's sponsor and chairman of the Senate subcommittee on securities, the proposed legislation:

> would abandon the rule 10b-5 requirement that the SEC prove fraud and show that the trader intended to deceive or defraud investors to whom he owed a duty. Instead, it would create a new section in the securities laws to supplement rule 10b-5 which would simply proscribe the unfair use of inside information. The SEC would no longer be required to prove that the insider had a special relationship with the person he was trading with or that the insider intended to defraud the other party.

The Insider Trading Sanctions Act of 1983: Hrgs. on H.R. 559 before Subcom. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 98th Cong., 2d Sess. 1 (April 3, 1984) ("1984 Hrgs."). John Shad, chairman of the SEC, and John Fedders, director of the SEC's Division of Enforcement, testified regarding the proposed legislation. Mr. Fedders noted six reasons supporting the passage of legislation defining insider trading. Among them: (1) "[B]y defining insider trading, Congress would establish the parameters of the illegal conduct . . . *The definition would permit Congress to prohibit the conduct it wants to make illegal.*" and (2) "a definition would permit Congress to clarify the law for the benefit of the investing public as well as the Commission and criminal prosecutors....Commentators have said that uncertainty remains in the law of insider trading ... *[J]ustice is too important to be left solely to judges and lawyers acting on a case-by-case ad hoc basis. Congress is our lawmaker. Clarification of the law by Congress would permit investors to chart their course of conduct confident in their obligations.*" 1984 Hrgs. at 35 (emphasis added). *See also* Testimony of SEC chairman Shad: "I think everyone who has addressed this area initially feels intuitively and emphatically that we should have a definition [of insider trading]." *Id.* at 57.

Having identified the need for clarification in the law, however, the SEC ultimately opposed enactment of legislation defining and codifying the misappropriation theory because "a definition of insider trading for purposes of enforcement actions under rule 10b-5 may reduce the Commission's flexibility to prosecute evolving types of conduct." In Fedders' words, "drafting a comprehensive definition is enormously difficult" while the existent "antifraud provisions work so well" because they "provide the Commission with the flexibility on a case-by-case basis." *Id.* at 37. Respondent respectfully submits that the flexibility desired by the SEC constitutes ambiguity in the context of a criminal prosecution in contravention of the fair notice requirement of the due process clause.

"tolerate the arbitrariness and unfairness of a legal system in which the judges would develop standards for imposing criminal punishment on a case-by-case basis"). Moreover, defining the misappropriation theory on an essentially ad hoc basis amounts to a retroactive application of the law and, because a defendant is not provided fair notice, also offends the *ex post facto* clause. *Lynce v. Mathis*, __ U.S. __, 117 S.Ct. 891, 896 (1997) (noting that one of the central concerns of the ex post facto clause is "the lack of fair notice" as to what is illegal or as to the level of punishment ascribed to conduct). Flexible interpretations of regulatory statutes that incrementally expand a statute beyond its original purposes, although perhaps defensible in occasional and highly unusual civil enforcement contexts, are impermissible in criminal prosecutions, and, for that reason, respondent's conviction under the misappropriation theory cannot stand. *Crandon v. United States*, 494 U.S. 152, 158 (1990) (When applying *criminal* statute, "it is appropriate to apply the rule of lenity in resolving any ambiguity in the ambit of the statute's coverage.").

II. THE SEC EXCEEDED ITS RULEMAKING AUTHORITY WHEN IT PROMULGATED RULE 14e-3

Pursuant to authority conferred by Congress, the SEC has the power to promulgate rules in connection with its responsibility to oversee the securities markets. 15 U.S.C. § 79t. However, the power to make rules "is not the power to make law -- for no such power can be delegated by Congress -- but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute." *Manhattan General Equip. Co. v. Commissioner*, 297 U.S. 129, 134 (1936); *see also Ernst & Ernst*, 425 U.S. at 214 (1976). A regulation that exceeds these mandates "operates to create a rule out of harmony with the statute [and] is a mere

nullity." *Manhattan General*, 297 U.S. at 134; *see also Securities Indus. Ass'n v. Board of Governors*, 468 U.S. 137, 143 (1984).[35]

The SEC promulgated Rule 14e-3 within months of this Court's opinion in *Chiarella*, *supra*, in a deliberate attempt to overrule *Chiarella*'s mandate that common law concepts of fraud must be proven for a §10(b) violation. Rule 14e-3 departs from its statutory mandate and established law by imposing liability in the absence of any fiduciary breach, and thereby criminalizes conduct that the SEC, and not Congress, decides is "fraudulent." Rule 14e-3 also improperly extends §14(e) to prohibit trading in advance of a tender offer, without providing fair notice of when a violation occurs and without requiring scienter. Accordingly, the SEC exceeded its rulemaking authority and Rule 14e-3 is invalid.

A. The Language Of §14(e) Constrains The SEC's Rulemaking Authority By The Common Law Definition Of Fraud.

Because the validity of Rule 14e-3 turns on the scope of conduct that may be regulated by §14(e), the plain language of the statute is

[35] While deference is to be accorded an interpretation of a statute provided by an agency charged with its enforcement, *Chevron, U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-45 (1984), such deference is "improper" if "the statute, as a whole, clearly expresses Congress' intention." *Dunn*, 117 S.Ct. at 920 n.14 (citing *Dole v. Steelworkers*, 494 U.S. 26, 42 (1990)); *see also Presley v. Etowah County Comm'n*, 502 U.S. 491, 508 (1992) ("As in other contexts in which we defer to an administrative interpretation of a statute, we do so only if Congress has not expressed its intent with respect to the question."); *IBT v. Daniel*, 439 U.S. 551, 566 n.20 (1979) ("[D]eference is constrained by our obligation to honor the clear meaning of a statute, as revealed by its language, purpose, and history.") Accordingly, this Court has not hesitated to reject SEC interpretations of provisions of the Securities Acts which are inconsistent with the statute. *See, e.g., Aaron*, 446 U.S. at 694 n.11 (1980); *SEC v. Sloan*, 436 U.S. 103, 199-21 (1978); *Chris-Craft Industries, Inc.*, 430 U.S. at 41 n.27; *Ernst & Ernst*, 425 U.S. at 213-14; *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 858 n.25 (1975); *Blue Chip Stamps*, 421 U.S. at 759 n.4; *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 425-27 (1972).

controlling. *Central Bank*, 114 S.Ct. at 1447. The pertinent language of §14(e) is virtually identical to the language of §10(b):

Section 14(e)	Section 10(b)
It shall be unlawful for any person * * * *to engage in any fraudulent, deceptive, or manipulative acts or practices*, in connection with any tender offer * * * The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative. 15 U.S.C. §78n(e).	It shall be unlawful for any person * * * *to use or employ*, in connection with the purchase or sale of any security * * * *any manipulative or deceptive device or contrivance* in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. 15 U.S.C. §78j.

Section 14(e) is a "'broad antifraud prohibition,' modeled on the antifraud provisions of §10(b) of the [Exchange] Act and Rule 10b-5." *Schreiber*, 472 U.S. at 10 (citation omitted). Sections 14(e) and 10(b) both proscribe "deceptive" and "manipulative" acts, and both authorize the SEC to implement the provisions by "rules and regulations." The language of §14(e) differs only in its specific prohibition of "fraudulent" activities, and thus emphasizes fraud as the essence of a violation of §14(e). *See id.* at 10 n.10. Given the textual similarities between two sections of the same statutory enactment, the case law construing §10(b) cannot be ignored when interpreting §14(e). *See Gustafson v. Alloyd Co.*, 115 S.Ct. 1061, 1066 (1995) ("In seeking to interpret the term 'prospectus,' we adopt the premise that the term should be construed, if possible, to give it a consistent meaning throughout the Act. That principle follows from our duty to construe statutes,

not isolated provisions.") (citations omitted); *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 297 (1993).

In *Schreiber*, 472 U.S. at 5-6, this Court determined the meaning of the term "manipulative" under §14(e) by looking to its prior decisions construing "manipulative" under §10(b) as well as the common law definition. In rejecting the view that "manipulative" encompasses any "unfair" conduct, the Court stated that §14(e) is not "an invitation to the courts to oversee the substantive fairness of tender offers." *Id.* at 12. Rather, as the Court held, the term "manipulative" required misrepresentation or nondisclosure in conformity with §10(b). *Id.* at 7-8.

It is beyond dispute that fraud under §10(b) requires proof of a breach of fiduciary duty. *Chiarella*, 445 U.S. at 228; *Dirks*, 463 U.S. at 656. In setting the contours of fraud, *Chiarella* returned to common law principles, stating:

> One who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information "that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."

445 U.S. at 228 (quoting *Restatement (Second) of Torts* §551(2)(a)). *Chiarella* explicitly rejected the SEC's position -- replicated here with respect to tender offers -- that any trading on material nonpublic information is fraudulent because it gives certain buyers or sellers an unfair advantage. *Id.* at 232. *Chiarella* found that the imposition of such a broad duty to disclose in the absence of any fiduciary relationship would "depart radically from ... established doctrine ... [and] should not be undertaken absent some explicit evidence of congressional intent." *Id.* at 233. *Dirks* confirmed that fraud under §10(b) requires a showing that the accused violated an affirmative duty to speak, and again rejected

the SEC's request to adopt a parity-of-information rule. 463 U.S. at 654.[36]

In accordance with *Schreiber*, *Chiarella* and *Dirks*, the term "fraudulent" under §14(e) must be accorded its common law definition requiring a breach of duty. *See also United States v. Turley*, 352 U.S. 407, 411 (1957) (explaining that "where a federal criminal statute uses a common-law term of established meaning without otherwise defining it, the general practice is to give that term its common-law meaning"). Accordingly, as the court below properly found, the SEC exceeded its statutory mandate when it promulgated Rule 14e-3, which requires no such breach.

The government argues that the second sentence of §14(e), added by Congress in 1970, grants the SEC broader rulemaking powers than does §10(b), in that the use of the word "define" indicates that the SEC can redefine and set forth the meaning of fraud under the statute.[37] The plain language of this rulemaking

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[36] While §10(b) does not contain the term "fraudulent," it is well settled that "what it catches must be fraud." *Chiarella*, 445 U.S. at 235. The fact that the principles announced in *Chiarella* and *Dirks* were based on the common law meaning of fraud rather than the text of §10(b) indicates further that these principles apply with equal force to §14(e). *See Chestman*, 947 F.2d at 586 (Mahoney, J., dissenting) ("No reason appears why this generally applicable rule of law, not derived in any way from the language or history of section 10(b) and rule 10b-5, should have definitive force in the construction and interpretation of those provisions, but none where section 14(e) and rule 14e-3(a) are concerned."). As the court below noted, "[i]t is inexplicable to us why this Restatement rule [cited in *Chiarella*], should have definitive force in the §10(b) context but not in the §14(e) context, especially in light of the fact that the two sections are part of the same statutory scheme." 92 F.3d at 626.

[37] The government argues that the enabling provision of §14(e) was modeled after the rulemaking language of §15(c)(2) of the Exchange Act, 15 U.S.C. §78o(c)(2), which prohibits fraudulent broker and dealer practices. (Govt. Br. at 39). §15(c)(2) does not permit the SEC to redefine fraudulent practices any more than §14(e) does. The government points to four rules that had been promulgated under §15(c)(2) as of 1970 which identify "a number of practices that had not constituted common law fraud." (Govt. Br. at 39 n.22). Not one of those rules prohibits trading on material information in the absence of fiduciary breach, and the validity of those rules is neither before this Court nor relevant to the question of Rule 14e-3's validity.

provision, however, directs the SEC to define "such acts and practices *as are fraudulent*, deceptive or manipulative," not to redefine "fraud." The use of the qualifying phrase "as are fraudulent" indicates that the SEC is authorized to identify and proscribe specific acts within the established meaning of fraud, not to determine what elements comprise fraud in the securities context. The government's interpretation would render the use of the phrase "as are fraudulent" superfluous, and the meaning of the word "fraudulent" irrelevant. *Chestman*, 947 F.2d at 584 (Mahoney, J., dissenting); *cf. Dunn*, 117 S.Ct. at 917 ("[L]egislative enactments should not be construed to render their provisions mere surplusage.").

The very argument the government is now making concerning the enabling provision was explicitly rejected in *Schreiber* with regard to the term "manipulative":

> In adding the 1970 amendment, Congress simply provided a mechanism for defining and guarding against those acts and practices which involve material misrepresentation or nondisclosure. The amendment gives the Securities and Exchange Commission latitude to regulate nondeceptive activities as a "reasonably designed" means of preventing manipulative acts, *without suggesting any change in the meaning of the term "manipulative" itself.*

472 U.S. at 11 n.11 (emphasis added).[38] It is difficult to discern why Congress would intend to change the meaning of the term "fraudulent" but not the meaning of the term "manipulative" in the same statutory provision, particularly since "[a]ll three species of

[38] The government partially quotes this language from *Schreiber* arguing that the phrase "latitude to regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts" supports its position, while conveniently ignoring the remaining language of the same sentence: "without suggesting any change in the meaning of the term 'manipulative' itself." (Govt. Br. at 40). As the court below found, "[p]roperly read, this provision means simply that the SEC has broad regulatory powers in the field of tender offers, but the statutory terms have a fixed meaning which the SEC cannot alter by way of an administrative rule." 92 F.3d at 627.

misconduct, i.e., 'fraudulent, deceptive, or manipulative,' listed by Congress are directed at failures to disclose." *Id.* at 8.[39]

Because the "explicit evidence of congressional intent" required for the SEC's dramatic departure from established doctrine, *Chiarella*, 445 U.S. at 233, is not manifested by §14(e), Rule 14e-3 is an invalid exercise of the SEC's statutorily-defined authority -- especially in the criminal context: "This is a truly breathtaking construction of a delegation to the SEC, we must bear in mind, of the authority to prescribe a federal felony." *Chestman*, 947 F.2d at 584 (Mahoney, J., dissenting).[40]

B. The Legislative History Of Section 14(e) Does Not Indicate That Congress Intended To Authorize The SEC To Redefine Fraud.

Because the text of §14(e) does not permit the SEC to redefine fraud, "that conclusion resolves the case." *Central Bank*, 114 S.Ct. at 1448; *see also Dunn*, 117 S.Ct. at 921. Nevertheless, the Government suggests that the legislative history of §14(e), which this Court has recognized as "sparse," *Schreiber*, 472 U.S. at 11, supports its interpretation that the SEC is authorized to depart from the common law and proscribe conduct in the absence of fiduciary breach.

[39] In support of its position, the government relies primarily on the Second Circuit's decision in *Chestman*. In *Chestman*, however, the court found that Rule 14e-3 was valid because, notwithstanding the text of §14(e), the rule retained "a *close nexus* between the prohibited conduct and the statutory aims." *Id.* at 560 (emphasis added). This holding is untenable under *Central Bank*, which made clear that the substantive text of the statute determines the scope of prohibited conduct. 114 S.Ct. at 1447. In addition, *Chestman* improperly interpreted subsequent congressional enactments in 1984 and 1988 as support for the status quo. As explained *infra*, this too is impermissible under *Central Bank*, 114 S.Ct. at 1453.

[40] The government suggests that Rule 14e-3 represents good policy because "the difficulties of establishing such a breach [of fiduciary duty] may permit sophisticated insider trading to go unpunished." (Govt. Br. at 44). Policy arguments, however, are "best addressed to the Congress, not the courts." *Dunn*, 117 S.Ct. at 921.

As a result of the increased frequency of cash tender offers in the mid-1960s,[41] which were unregulated and conducted in virtual secrecy,[42] Congress passed the Williams Act in 1968. Two years later, it enacted a rulemaking provision to "give the Commission rulemaking power with respect to fraudulent, deceptive, and manipulative techniques in tender offers." Statement by Senator Williams, 116 Cong. Rec. 3024 (1970). Nowhere does the record show that Congress intended that the SEC redefine fraud and regulate insider trading in the absence of fiduciary breach.[43]

The Government points to one memorandum sent to Congress by the SEC which identified trading on the basis of material facts concerning a tender offer as a possible "problem area" where the proposed rulemaking powers might be invoked. (Govt. Br. at 43.) Because the memorandum made no mention of fiduciary breach, the government argues, Congress must have intended to authorize the SEC to redefine fraud. *Id.* This memorandum, however, was not prepared by Congress. "If legislative history is to be considered, it is preferable to consult the documents prepared by

[41] The number of tender offers increased from 8 in 1960 to over 100 in 1966. *See* Janell M. Kurtz & Bradley J. Sleeper, *Fraud Liability for Outsider Trading: SEC Rule 14e-3 in Limbo*, 29 Am. Bus. L. J. 691, 693 (1992).

[42] Prior to 1968, the federal securities laws required full disclosure of information to investors in proxy contests, 15 U.S.C. §78n, and stock-for-stock exchanges, 15 U.S.C. §77e, but not cash tender offers.

[43] On the contrary, given that the 1970 amendment was passed "in the early years of the tender offer phenomenon and its attendant regulation. ... the plain meaning of the dispositive language is that the SEC is empowered to identify and regulate, in this (then) novel context, the 'acts and practices' that fit within the existing legal categories of the 'fraudulent, deceptive, or manipulative,' but not to redefine the categories themselves." *Chestman*, 947 F.2d at 584 (Mahoney, J., dissenting). Indeed, the SEC did not even declare its view that "insider trading" constituted a violation of §10(b) until its 1961 decision in *In re Cady, Roberts & Co*, 40 S.E.C. 907 (1961). The first court to even consider the theory was the Second Circuit in *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). There was hardly a body of case law governing insider trading in 1970, and there is no indication Congress intended to regulate such trading under §14(e), much less allow the SEC to redefine fraud to cover trading of "outsiders" absent any fiduciary breach.

Congress when deliberating." *Gustafson*, 115 S.Ct. at 1072; *see also Piper*, 430 U.S. at 31 n.20 ("Remarks ... made in the course of legislative debate or hearings other than by persons responsible for the preparation or the drafting of a bill are entitled to little weight.") (quoting *Ernst & Ernst*, 425 U.S. at 204 n.24). Furthermore, this memorandum was sent to Congress *after* the hearings regarding the rulemaking provision had concluded, and there is no evidence that any Congressman even read the memorandum. "Material not available to the lawmakers is not considered, in the normal course, to be legislative history." *Gustafson*, 115 S.Ct. at 1071.[44]

C. Rule 14e-3 Improperly Extends §14(e) To Prohibit Trading In Advance Of A Tender Offer, Without Providing Notice As To When A Violation Occurs And Without Requiring Scienter.

Section 14(e) prohibits fraudulent acts "in connection with a tender offer." The plain language of the statute indicates that violations of §14(e) cannot occur unless and until a tender offer is made. This reading is consistent with Congress' intent to address the exigencies of tender offer situations where shareholders are often called upon to act quickly: "The sole purpose of the Williams Act was the protection of investors *who are confronted with a tender offer*." *Piper*, 430 U.S. at 35 (emphasis added); *see also Schreiber*, 472 U.S. at 8 ("The purpose of Williams Act is to ensure that public shareholders who are confronted by a cash tender offer for their stock will not be required to respond without

[44] Even assuming Congress considered the memorandum, the specified "problem area" is too broad to provide any delineation of the scope of the rulemaking provision. In addition to failing to mention breach of duty, the memorandum fails to mention the source of the individual's discovery. Hence this memorandum, as interpreted by the government, authorizes the prosecution of a person who trades after observing heavy trading in a target company's stock. *Chestman*, 947 F.2d at 585 (Mahoney, J., dissenting); *see also* William J. Cook, *From Insider Trading to Unfair Trading: Chestman II and Rule 14e-3*, 22 Stetson L. Rev. 171, 193-94 (1992).

adequate information."); *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49 (1975). Rule 14e-3 exceeds its statutory mandate by criminalizing conduct "[i]f any person *has taken a substantial step or steps to commence*, or has commenced, a tender offer." 17 C.F.R. 240.14e-3(a) (emphasis added). Accordingly, Rule 14e-3 is invalid.[45]

The government's extension of §14(e) to include pre-offer conduct has resulted in an unreasonable rule that fails to comport with due process on two levels. First, Rule 14e-3 does not define "substantial steps," and thus fails to give fair notice as to when, in advance of a tender offer, a violation of §14(e) occurs. Conflicting decisions among the lower courts have only furthered the confusion. *Compare Frankel v. Slotkin*, 705 F. Supp. 105, 109 (E.D.N.Y. 1989) (dismissing claim under §14(e) where three months had elapsed between receipt of confidential information and the tender offer); *with SEC v. Mayhew*, 916 F. Supp. 123, 125, 130 (D. Conn. 1995) (substantial steps were taken two months prior to merger announcement when companies jointly retained a business consulting firm and individually retained bankers and

[45] Prior to the enactment of Rule 14e-3, the majority of lower courts held that that the duty to disclose under §14(e) was not triggered until a tender offer was made or, in the merger context, when an agreement in principle had been reached. *See, e.g., Sanders v. Thrall Car Mfg.*, 582 F. Supp. 945, 966 (S.D.N.Y. 1983) (§14(e) was "never intended to serve an omnibus police function, but rather [was] intended to ensure full and fair disclosure in the more limited context of *the offer itself*") (emphasis added); *Missouri Portland Cement Co. v. H.K. Porter Co.*, 535 F.2d 388, 398 (8th Cir. 1976); *Susquehanna Corp. v. Pan Am. Sulphur Co.*, 423 F.2d 1075, 1084-85 (5th Cir. 1970); *Berman v. Gerber Prods. Co.*, 454 F. Supp. 1310, 1318 (W.D. Mich. 1978); *Crane Co. v. Anaconda Co.*, 411 F. Supp. 1208, 1210 (S.D.N.Y. 1975). The only "pre-offer" conduct held to fall within the purview of §14(e) were statements made by the offeror or target company after a *public announcement* of a forthcoming offer (but prior to the actual effective date of the offer). *See Lewis v. McGraw*, 619 F.2d 192, 195 (2d Cir.), *cert. denied*, 449 U.S. 951 (1980); *Applied Digital Data Sys., Inc. v. Milgo Elec. Corp.*, 425 F. Supp. 1145, 1152 (S.D.N.Y. 1977); *Anaconda Co. v. Crane Co.*, 411 F. Supp. 1210, 1215 (S.D.N.Y. 1975); *ICM Realty v. Cabot, Cabot & Forbes Land Trust*, 378 F. Supp. 918, 921-22 (S.D.N.Y. 1974).

lawyers). The SEC endorses this *ad hoc* application, arguing that "[w]hat constitutes a 'substantial step' for purposes of Rule 14e-3 must be determined on the facts of each case." Brief of the SEC, *SEC v. Mayhew*, No. 96-6022, 96-6092 (2d Cir. June 8, 1996) at 24. While this amorphousness might be acceptable in the civil context, it is clearly impermissible as the basis for criminal liability. *Kozminski*, 487 U.S. at 951.

Second, Rule 14e-3 effectively disposes of any scienter requirement, in repudiation of established law. *See Dirks*, 463 U.S. at 663 n.23 ("Scienter -- 'a mental state embracing intent to deceive, manipulate, or defraud,'-- is an independent element of a Rule 10b-5 violation.") (citations omitted); *Ernst & Ernst*, 425 U.S. at 199 (violation of §10(b) requires "intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities"); *Aaron*, 446 U.S. at 698 (§17(a)(1), which makes it unlawful "to employ any device, scheme, or artifice to defraud," proscribes only knowing or intentional misconduct). There is no requirement in Rule 14e-3 that the defendant know that the offeror has commenced the triggering "substantial steps." As the district court instructed the jury below, pursuant to the government's request: "[N]or is it necessary that you find that the defendant know the substantial steps had been taken. It is enough that you find one or more substantial steps were in fact taken." (JA 205). Under the SEC's interpretation, an individual may now be criminally prosecuted under §14(e) without any knowledge of any tender offer.

This interpretation of §14(e) defies the entire purpose of the Williams Act, as quoted by the government in its brief: "The Williams Act accordingly requires that persons 'engaged in making or opposing tender offers or otherwise seeking to influence the decision of investors or the outcome of the tender offer' must make full disclosure of material information in their possession before trading." (Govt. Br. at 41 (citations omitted)). It is inexplicable how an individual can "seek to influence the decision of investors or the outcome of the tender offer" if he is unaware of the tender offer itself. *Cf. Manhattan General*, 297 U.S. at 134 ("[N]ot only

must a regulation, in order to be valid, be consistent with the statute, but it must be reasonable.").

A crucial and necessary function of criminal law is to advise citizens of what conduct is permissible and what is not. *Aguilar*, 115 S. Ct. at 2362; *Grayned*, 408 U.S. at 108. The danger of the SEC's unwarranted expansion of the securities law to such an indefinite and arbitrary criminal law is illustrated by the facts of this case. Grand Met made its tender offer on October 4, 1988. Respondent was convicted of trading after allegedly learning confidential information from Tinkham on August 26 -- almost six weeks prior to the tender offer. The undisputed evidence shows that, even as of September 18, 1988, while Grand Met had made a decision "in principle that [it] would like to acquire Pillsbury," "the decision to actually launch the hostile tender offer had not been taken." (JA 183). Moreover, respondent had no knowledge of any decision made *by Grand Met* because, as the district court found, "the record says [respondent] didn't know it was Grand Met's information." (JA 167). As viewed most favorably to the government, then, the only information respondent allegedly learned from Tinkham was that an undisclosed client had retained local counsel in connection with an interest in Pillsbury. In accordance with due process, respondent could not have had fair notice that his trading was "in connection with a tender offer" when he learned nothing about the client or any purported "substantial steps" -- and there was nothing to learn, since Grand Met itself had not even decided on the offer. Due process requires clearer notice than respondent received and less ambiguity than that against which he had to defend.

III. CONGRESSIONAL ACQUIESCENCE IN, OR "VALIDATION" OF, THE MISAPPROPRIATION THEORY AND RULE 14e-3 IS NO SUBSTITUTE FOR LEGISLATIVE CODIFICATION

"Congress has not reenacted the language of §10(b) since 1934." *Central Bank*, 114 S.Ct. at 1452. Nonetheless, the Government contends that one can find in the legislative history of

the Insider Trading Sanctions Act of 1984 ("the 1984 Act") and the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA") references to, and congressional validation of, both the misappropriation theory and Rule 14e-3. In condemning the use of post-enactment legislative history in statutory interpretation, however, this Court has stated that: "the interpretation given by one Congress (or committee of Member thereof) to an earlier statute is of little assistance in discerning the meaning of that statute." *Central Bank*, 114 S. Ct. at 1452 (citations omitted). Just last month, this Court rejected a similar argument made by the Commodities and Futures Trading Commission ("CFTC") concerning statements made by Congress when it amended the Commodities & Exchange Act ("CEA"):

> The CFTC calls our attention to statements in the legislative history of a 1982 amendment to the CEA.... Those statements, at best, might be described as "legislative dicta" because the 1982 amendment .... made no change in the law applicable to off-exchange trading. Although the "dicta" is consistent with the position that the CFTC advocates, it sheds no light on the intent of the authors of the Treasury Amendment that had been adopted eight years earlier.

Dunn, 117 S.Ct. at 920.

Even if this Court were to entertain this subsequent "legislative dicta," the failure of Congress to overturn an agency's interpretation of a statute -- indeed, even enthusiastic congressional support for an agency's interpretation of a statute expressed in committee reports or floor debate -- cannot override the text of the statute. "Congress may legislate only through passage of a bill which is approved by both Houses and signed by the President." *Central Bank*, 114 S.Ct. at 1453 (citing U.S. Const. art. I, §7, cl.2).[46] Congress has not, through legislation, codified either the misappropriation theory or rule 14e-3.

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[46] *See Brown v. Gardner*, 115 S. Ct. 552, 556-57 (1994) (textually grounded conclusion overrides regulatory practice of Department of Veterans, even though that practice had purportedly been endorsed by 60 years of legislative silence);

In its brief as amicus curiae, the North American Securities Administrators Association ("NASAA"), joined by a group of law professors, claim what the government does *not* claim -- that Congress "confirmed and codified" the misappropriation theory by the sanctions legislation enacted in 1984 and 1988. NASAA bases its contention with respect to the 1984 Act on language which created a new §20(d) to the Exchange Act, 15 U.S.C. §78t(d), making it illegal to trade options while in possession of material, nonpublic information if it would be illegal to trade the underlying stock. NASAA argues that because publicly traded options are issued by dealers, to whom no fiduciary duty is owed by those trading in options, the prohibition against option trading cannot be predicated on a breach of duty to a trading partner. According to the amici, this "extension [of the Exchange] Act, makes sense only on the assumption that Congress already believed that any person trading on misappropriated material nonpublic information was violating Section 10(b) and Rules 10b-5 [without regard to any breach of duty], and Section 20(d) of the Exchange Act codified this belief as substantive law." (NASAA Br. at 18.) Amici's conclusion is not logically required.

Moreover, what "makes sense" to the amici and what Congress actually legislated are two different things. The focus of the 1984 Act was on augmenting enforcement sanctions. The House Report which was the only report to accompany the legislation when it was considered by the full Congress makes no mention of the new §20(d) at all, nor does it give any indication to the members who would vote on the legislation that the authors of the bill intended, through the addition of 20(d), to implicitly amend §10(b) to codify the misappropriation theory. *See* H.R. Rep. No. 355, 98th Cong.,

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Aaron, 446 U.S. 680, 694 n. 11 (1980) ("[T]he failure of Congress to overturn the Commission's interpretation falls far short of providing a basis to support a construction of §10(b) so clearly at odds with its plain meaning and legislative history."); *Sloan*, 436 U.S. at 119-20 & n. 10; *Rivers v. Roadway Express*, 114 S.Ct. 1510, 1519 (1994) (Congress has the power to amend a statute that Congress believes has been misconstrued by the courts; no such change has the force of law, however, unless the change is implemented through legislation).

1st Sess. (1983). Most importantly, the amici's suggestion that Congress, through enactment of §20(d), must have intended *implicitly* to codify the misappropriation theory ignores the fact that the congressional committees which considered the 1984 legislation rejected a proposal to codify *explicitly* the misappropriation theory. *See* discussion at n. 34, *supra*. Whatever may have been the views of individual members of Congress regarding the validity of the misappropriation theory in 1984, the sanctions legislation actually enacted cannot be said to have codified the misappropriation theory.

The reliance by the government and its amici on the 1988 ITSFEA is even more misplaced. This legislation was enacted *after* the conduct for which respondent was prosecuted had occurred. It cannot, consistent with the *ex post facto* clause, have any applicability to respondent. *See Calder v. Bull*, 3 Dall. 386, 390 (1798). Moreover, to the extent the legislative history of ITSFEA is used to suggest that Congress, in 1988, regarded the misappropriation theory and rule 14e-3 as proper interpretations of statutes enacted by a prior Congress, such legislative history is irrelevant. *See Central Bank*, 114 S.Ct. 1452-53; *United States v. X-Citement Video*, 513 U.S. 64, 115 S.Ct. 464, 471 n.6 (1994).

Congress' finding in Section 2 of ITSFEA that "the rules and regulations of the [SEC] ... are necessary and appropriate in the public interest and for the protection of investors" does not answer the question of whether the misappropriation theory and rule 14e-3 constitute valid interpretations of §10(b) and §14(e), the statutes under which respondent was indicted.

The amici's reliance on §20A is similarly misplaced. The amici point to language in a committee report indicating that §20A was enacted in response to *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5 (2d Cir. 1983), a Second Circuit case which had applied the misappropriation theory but found no authorization for a private right of actions against those who trade on the basis of misappropriated information. The amici contend that the mechanism used to create a private remedy in 1988, thus, "is predicated on the validity of the misappropriation theory." Section

20A, however, provides that any person "who *violates* any provision of this title or the rules or regulations thereunder," by trading in a security "while in possession of material, nonpublic information shall be liable ... to any person who, contemporaneously ..." purchased or sold the same class of security on the opposite side of the market. (Emphasis added). Congress did not define what constitutes a violation, and it did not codify a misappropriation theory in 1988, but rather left it to the courts to define the conduct that gives rise to liability under §10(b). Harold S. Bloomenthal, et al. *Securities Law Handbook* at 1188 ([§20A] does not define what is a violation; such violation depends upon the substantive law.") *See* H.R. Rep. No. 910, 100th Cong., 2d Sess. 11 (1988).

In sum, although Congress has enhanced the penalty provisions of the securities laws for insider trading twice in the past thirteen years, it has, on both occasions, declined to define the conduct that gives rise to these severe criminal penalties. *See Central Bank*, 114 S.Ct. at 1453 (noting that "Congress has acknowledged the 10b-5 action without any further attempt to define it."). Specifically, Congress has not, as the amici claim, codified either the misappropriation theory or rule 14e-3. Thus, neither the 1984 Act nor ITSFEA, nor the legislative history accompanying this legislation, is determinative of any issue in this case.

IV. THE REVERSAL OF RESPONDENT'S MAIL FRAUD CONVICTIONS DOES NOT CONTRAVENE *CARPENTER*

The court below specifically acknowledged *Carpenter* and stated: "The mere fact that O'Hagan's securities convictions have been reversed does not as a matter of law require that the mail fraud convictions likewise be reversed." 92 F.3d at 627. However, the court reversed the mail fraud convictions because "the indictment was structured in such a manner as to *premise* the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud." *Id.* (emphasis added); *see also Chestman*, 947 F.2d at 571 (after acknowledging *Carpenter*, reversing mail fraud

convictions because "[t]he same fraudulent scheme that underlay the Rule 10b-5 convictions [which were reversed] also was the basis for the mail fraud convictions"). The "scheme to defraud" for *both* the securities and mail fraud counts was charged in Paragraph 2 of the indictment as follows:

> From on or about August 26, 1988, and continuing until approximately October 17, 1988, defendant JAMES HERMAN O'HAGAN engaged in a scheme to defraud Grand Met and Dorsey and Whitney *in connection with the purchase and sale of securities* by purchasing Pillsbury common stock and call options on Pillsbury common stock while in the possession of material, non-public information concerning Grand Met's future tender offer for Pillsbury common stock.

(JA 8). The indictment specifically incorporates the statutory language of §10(b) as an element of mail fraud, as it charges that the "scheme to defraud" element of mail fraud is a scheme "in connection with the purchase and sale of securities."[47] Once the court found that there was no fraud "in connection with the purchase and sale of securities" for purposes of §10(b), there could not be any fraud "in connection with the purchase and sale of securities" to constitute mail fraud as charged in the indictment. Furthermore, Paragraph 3 of the indictment explicitly states: "It was part of the scheme and artifice to defraud that defendant ... engage[d] in acts which operated to defraud Grand Met and Dorsey and Whitney in violation of [§§10(b) and 14(e)]." (JA 9). Again, the "scheme to defraud" is a specific element of mail fraud. Accordingly, the mail fraud convictions were properly reversed.

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[47] Hence, contrary to the government's suggestion, the indictment did charge "as an element of the [mail fraud] offense, that respondent had committed mail fraud by using the mails to commit violations of the securities laws." (Govt. Br. at 47).

The lower court's holding is based on the indictment and thus is not contrary to *Carpenter*.[48] The *Carpenter* indictment did not charge a scheme to defraud "in connection with the purchase or sale of securities" for its mail fraud counts. (Resp. App). Hence, the conflict which the government seeks to create between this case and *Carpenter* simply does not exist. The court of appeals' reversal of the mail fraud convictions reflects a proper construction of the indictment *in this case*, and should be affirmed. Even if the Court were to disagree, respondent presented substantial, alternative bases for reversal of the mail fraud convictions which have not been addressed by the court below.[49] Thus, the proper remedy, in the event the Court does not affirm the reversal of the mail fraud convictions, would be to remand to the court of appeals for consideration of the alternative bases for reversal.

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[48] The Court in *Carpenter* affirmed both the securities fraud and mail fraud counts. Hence, contrary to the government's suggestion, *Carpenter* does not stand for the broad proposition that "mail fraud charges are independent of securities fraud charges, even when both rest on the same set of facts." (Govt. Br. at 46-47).

[49] Among the alternative grounds for reversal of the mail fraud conviction is the government's failure to charge an actionable offense because the confirmation slips -- which constitute the sole use of the mails alleged in the indictment: (1) were required by federal law and thus, cannot, as a matter of law, be made the basis for liability; and (2) in any event, were not mailings "in furtherance" of the alleged fraud. *See Parr v. United States*, 363 U.S. 370, 391 (1960); *Schmuck v. United States*, 409 U.S. 705 (1989). Another ground for reversal is the district court's error in charging the jury that respondent committed fraud if he purchased securities *while in possession* of material, nonpublic information without requiring that respondent be found to have traded *on the basis* of the information. See *Chiarella*, 445 U.S. at 235.

Respondent presented alternative bases for reversal of the §10(b) and §14(e) convictions as well. Thus, if this Court does not affirm the judgment of the court of appeals in all respects, petitioner is not entitled to reinstatement of the convictions entered below but is, instead, entitled only to an order remanding this case to the court of appeals for further proceedings.

CONCLUSION

For all the foregoing reasons, the judgment of the United States Court of Appeals for the Eighth Circuit reversing respondent's convictions on all counts should be affirmed.

Dated: March 28, 1997

Respectfully submitted,

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APPENDIX

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

UNITED STATES OF AMERICA -v- R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. ELLIS, Defendants.	SUPERSEDING INDICTMENT SS 84 Cr. 605 (CES)

COUNT ONE

The Grand Jury charges:

THE DEFENDANTS

1. R. FOSTER WINANS, the defendant, at all times relevant to this Indictment up to March 28, 1984, was employed by the Wall Street Journal and its parent corporation Dow Jones & Company, Inc. at 22 Cortlandt Street, New York, New York. WINANS was assigned as one of two reporters principally responsible for the Journal's "Heard on the Street" column. WINANS also had a beneficial interest in certain bank and brokerage accounts maintained by or with DAVID CARPENTER.

2. DAVID CARPENTER, the defendant, from time to time relevant to this Indictment, maintained certain bank and stock brokerage accounts in which the defendant R. FOSTER WINANS shared a beneficial interest.

3. KENNETH P. FELIS, the defendant, at all times relevant to this Indictment, was employed as a registered representative by Kidder Peabody & Co., Incorporated ("Kidder Peabody") at 101 Park Avenue, New York, New York. FELIS also shares commissions and participated in a stock trading account with Peter N. Brant.

4. Peter N. Brant, named as a defendant in Information 84 Cr. 470, at all times relevant to this Indictment, was employed as a registered representative by Kidder Peabody at 101 Park Avenue, New York, New York. Brant also shared commissions and participated in a stock trading account with the defendant KENNETH P. FELIS.

THE WALL STREET JOURNAL

5. The Wall Street Journal at all times relevant to this Indictment was a newspaper published every business day by Dow Jones & Company, Inc. from editorial and publication headquarters at 22 Cortlandt Street, New York, New York. At all times relevant to this Indictment, certain of the content of Journal, including the "Heard on the Street" column, was transmitted on or about the day prior to publication by wire communication in interstate commerce from 22 Cortlandt Street, New York, New York to Chicopee, Massachusetts and Dallas, Texas for satellite transmission and printing at various locations. At all times relevant to this Information, the Journal had a circulation of approximately two million copies, including approximately 20,000 copies delivered by United States mail daily to subscribers in the Southern District of New York.

6. The "Heard on the Street" column at all times relevant to this Indictment appeared regularly in the Wall Street Journal and featured information, opinions and analyses concerning the prospects for certain industries in general and for particular companies and the securities of those companies. Readership surveys show that "heard on the Street" is one of the most popular features in the Journal. Among stocks featured in "Heard on the Street", those mentioned favorably tend to rise in price and those mentioned unfavorably end to decline in price on the day of publication.

Because of the market sensitivity of "Heard on the Street", the Wall Street Journal takes special measures to insure the confidentiality of the column up until the moment of publication.

THE CONSPIRACY

7. From on or about January 1, 1983, to on or about March 29, 1984, in the Southern District of New York and elsewhere, the defendants R. ROSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS and others to the Grand Jury known and unknown, including Peter N. Brant, unlawfully, wilfully and knowingly, did combine, conspire confederate and agree with and among each other to commit certain offenses against the United States, to wit: fraud in the purchase and sale of securities in violation of Title 15, United States Code, Section 78j(b) and 78ff and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5; mail and wire fraud in violation of Title 18, United States Code, Section 1341 and 1343; and obstruction of justice in violation of Title 18, United States Code, Section 1505.

8. It was a part of the conspiracy that the defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS and others to the Grand Jury known and unknown including Peter N. Brant, would and did directly and indirectly, and by use of means and instrumentalities of foreign and interstate commerce, the mails, and the facilities of national securities exchanges, (a) employ devices, schemes, and artifices to defraud, and (b) engage in acts, practices and courses of business in connection with the purchase and sale of securities, as set forth more fully below, which operated as a fraud and deceit on the Wall Street Journal and Dow Jones & Company, Inc.

9. It was further a part of the conspiracy that the defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS and others to the Grand Jury known and unknown including Peter N. Brant would and did devise a scheme and artifice to defraud and to obtain money by means of false and fraudulent pretenses, representations, and promises, and that to

execute the scheme, they would and did use and cause the use of the mails and wire communications in interstate commerce.

10. It was further a part of the conspiracy that the defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS and others to the Grand Jury known and unknown including Peter N. Brant, would and did corruptly endeavor to influence, obstruct and impede the due and proper administration of the law under which a pending proceeding was being had before a department and agency of the United States, to wit, an investigation directed by formal order of the Securities and Exchange Commission dated March 14, 1984.

OBJECTS TO THE CONSPIRACY

Among the objects of the Conspiracy were the following:

11. As a part of the conspiracy, the defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS and their co-conspirators agreed that WINANS would misappropriate from the Wall Street Journal and Dow Jones & Company, Inc. confidential, material, advance information which was entrusted by the Journal to WINANS by virtue of his employment concerning the subject matter, nature and timing of "Heard on the Street" columns and other articles scheduled to appear in the Journal. They agreed further that WINANS would covertly relay such information directly and indirectly to his co-conspirators. The defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS and co-conspirators would and did then buy stock in anticipation of favorable articles, and sell short in anticipation of unfavorable articles, and engage in comparable transactions in options for the securities of the companies which were scheduled to be the subject of "Heard on the Street" columns and other Journal articles, for the purpose of profiting from movements in the price of those securities after publication of the stories. In so doing WINANS, with the aid and support of the defendants DAVID CARPENTER and KENNETH P. FELIS and their co-conspirators, would and did breach the trust and confidence placed in WINANS by the Wall Street Journal and Dow Jones & Company, Inc.

12. As a part of the conspiracy, the defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS and their co-conspirators agreed that having traded in securities in anticipation of articles scheduled to appear in the Wall Street Journal, WINANS would and did write, obtain approval for and cause to be published "Heard on the Street" columns concerning the issuers of those securities, with the expectation of profiting from movements in the price of the securities in response to the articles, and without disclosing the foregoing circumstances to the Wall Street Journal. Subsequent to the publication of the "Heard on the Street" column or other articles leaked in advance, the defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS and their co-conspirators would and did sell the stock which had been purchased, or purchase stock in order to cover short sales, or engage in comparable options transactions calculated to profit from price movements in the securities in response to the Journal stories.

13. As a part of the conspiracy, the defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS and their co-conspirators agreed to cover up and endeavor to obstruct any investigation into the scheme by attempting to disguise payments by Peter Brant and FELIS to WINANS and CARPENTER as fees for "decorating services" ostensibly rendered by CARPENTER; by making false statements to Kidder Peabody, the Wall Street Journal and officers of the Securities and Exchange Commission, and by preparing false documents intended for submission to the Securities and Exchange Commission.

14. In attempting to achieve the objects of the conspiracy, R. FOSTER WINANS, with the aid and support of the defendants DAVID CARPENTER and KENNETH P. FELIS and their co-conspirators violated his fiduciary duties owed to the Wall Street Journal and Dow Jones & Company, Inc., including a duty of honesty, loyalty and silence, a duty not to use the news pages of the Wall Street Journal for his personal benefit, a duty to report to his superiors advance leaks of stories that he knew or believed to have caused trading in securities, a duty to refrain from trading in securities based upon advance knowledge of Wall Street Journal

articles, and a duty to report to his superiors any inadvertent trading for his benefit in securities that were to be the subject of a forthcoming article.

THE MEANS OF THE CONSPIRACY

Among the means employed by the defendants and their co-conspirators to effect the conspiracy and to carry out its unlawful object were the following:

15. On or about January 10 and 11, 1983, the defendants R. FOSTER WINANS and DAVID CARPENTER caused to be purchased in a brokerage account in CARPENTER's name 400 shares of the stock of American Surgery Centers Corp. at total cost of $1,814.17. Two days later, on or about January 10, 1983, WINANS wrote and caused to be published in the Wall Street Journal a favorable "Heard on the Street" column concerning American Surgery Centers Corp. On the days that the column appeared, the closing bid price for American Surgery Centers Corp. stock rose to $5.00, or approximately $.94 over the closing bid price on the day before the column.

16. On or about March 23, 1983, the defendant R. FOSTER WINANS wrote and caused to be published a generally favorable mention of American Surgery Centers Corp. in the "Heard on the Street" column. On the day that the column appeared, the closing bid price for American Surgery Centers Corp. stock rose to approximately $7.69, or approximately $.94 over the closing bid price on the day before the column.

17. On or about May 17, 1983, the defendants R. FOSTER WINANS and DAVID CARPENTER caused to be sold from the brokerage account in CARPENTER's name the 400 shares of American Surgery Centers Corp. stock for total proceeds of $4,673.64, for a profit of $2,859.47.

18. On or about April 28, 1983, the defendants R. FOSTER WINANS and DAVID CARPENTER caused to be purchased in a brokerage account in CARPENTER's name 1,000 shares of the stock of Institutional Investors Corp. at a total cost of $1,237.50.

19. On or about June 1, 1983, the defendant R. FOSTER WINANS wrote and caused to be published in the Wall Street Journal a favorable "Heard on the Street" column concerning Institutional Investors Corp. On the day that the column appeared, the closing price for Institutional Investors Corp. stock rose to approximately $1.63, or approximately $.38 over the closing price on the day before the column. Five days later on or about June 6, 1983, WINANS and the defendant DAVID CARPENTER caused to be sold from the brokerage account in CARPENTER's name the 1,000 shares of Institutional Investors Corp. stock for total proceeds of $1735.09, for a profit of $497.59.

20. In or about mid-1983, at a meeting at the Racquet & Tennis Club in Manhattan, the defendant R. FOSTER WINANS and Peter N. Brant discussed among other things the effect of the "Heard on the Street" column on the market price of securities.

21. On or about Sunday, October 16, 1983, during a discussion on a golf course in Long Island, the defendant R. FOSTER WINANS and Peter N. Brant agreed that WINANS would systematically disclose to Brant confidential advance information concerning the subject matter, nature and timing of "Heard on the Street" columns, in order for Brant to execute transactions in the securities or options for the securities of companies to be featured in the stories. WINANS and Brant agreed to share profits from such trading. Brant agreed to advance $15,000 to WINANS disguised in the form of a check payable to the defendant DAVID CARPENTER. On or about the same day, Brant advised the defendant KENNETH P. FELIS of the agreement.

22. On or about Monday, October 17, 1983, Peter N. Brant wrote a $15,000 check payable to DAVID CARPENTER and caused it to be delivered to the defendant R. FOSTER WINANS. On or about the same day, WINANS informed Brant the a generally favorable article concerning oil-service companies, including Schlumberger, Ltd., would appear in "Heard on the Street" on the following day. As a result of this conversation. Brant purchased common stock and call options for Schlumberger, Ltd. in accounts in the names of Brant and the defendant KENNETH P. FELIS at Kidder Peabody. Later on the same day, WINANS advised Brant that the column in question had been delayed until Wednesday, October 19, 1983. On or about Wednesday, October 19, 1983, the "Heard on the Street" column concerning Schlumberger, Ltd., and other oil-service companies appeared in the Wall Street Journal.

23. Over the next four and one-half months, the defendant R. FOSTER WINANS leaked advance information concerning approximately two dozen additional articles written by himself and others directly or indirectly to one or more of the defendants KENNETH P. FELIS and DAVID CARPENTER and to Peter N. Brant and others who caused securities to be purchased and sold on the basis of this information. In all, the conspirators gained illegal gross profits of approximately $900,000 at the expense of public investors, and also realized trading losses of approximately $225,000 as a result of this trading.

24. In or about the latter part of October, 1983, the defendants R. FOSTER WINANS and KENNETH P. FELIS and Peter N. Brant met on one or more occasions in Manhattan at the Racquet & Tennis Club, Nicola's Restaurant and elsewhere in order to introduce WINANS and FELIS, and to discuss various aspects of the scheme.

25. On or about Thursday, November 10, 1983, after approximately eleven stocks had been traded in accounts maintained in the names of the defendant KENNETH P. FELIS and another on the day before they appeared in "Heard on the Street", Kidder Peabody questioned FELIS and Peter N. Brant about the coincidence.

Brant and FELIS falsely stated that FELIS were merely mimicking trades initiated by one of Brant's customers, and that he had the customer's permission to engage in this practice. Kidder Peabody instructed Brant and FELIS that such trading in FELIS' account was to stop.

26. On or about the same day, the defendant KENNETH P. FELIS and Peter N. Brant decided to continue their trading through a Swiss bank. Brant contacted the Bank Institute of Zurich, through which he had previously done business on behalf of a customer, and discussed the use of "Western Hemisphere Trading Corporation," a Costa Rican corporation, in order to conduct the trading. On or about the following day, Friday, November 4, 1983, FELIS and Brant withdrew $275,000 from the account which they maintained in FELIS' name at Kidder Peabody and converted those funds into a bank check payable to Western Hemisphere Trading Corp.

27. On or about Saturday, November 5, 1983, the defendant KENNETH P. FELIS arrived in Spain on a prearranged vacation. In or about the following week, FELIS travelled to Switzerland and visited the Bank Institute of Zurich, where he deposited the $275,000 check. FELIS also arranged to "rent" the use of "Western Hemisphere Trading Corporation" for $1500 per month. FELIS then arranged for $250,000 to be wired back to Kidder Peabody in New York to fund the "Western Hemisphere Trading Corp. Account Number 2," and left $25,000 on deposit with the Bank Institute of Zurich on account of monthly fees.

28. On or about Thursday, November 10, 1983, Peter N. Brant gave the defendant R. FOSTER WINANS approximately $1,000 in British pounds as a portion of WINANS' share of the proceeds of the scheme, to be used by the defendant DAVID CARPENTER on a forthcoming trip to England.

29. On or about Thursday, December 1, 1983 and on four more occasions thereafter, the defendant KENNETH P. FELIS and Peter N. Brant resumed using information received from the defendant R. FOSTER WINANS to trade in securities in the name of Western Hemisphere Trading Corp. Account No. 2. On or about

December 5, 1983, $250,000 was wire transferred from the Bank Institute of Zurich to Kidder Peabody in New York to fund this trading.

30. On or about Wednesday, December 7, 1983, the defendant R. FOSTER WINANS met Peter N. Brant at the Polo Lounge at the Westbury Hotel in Manhattan and received a $5000 check from Brant payable to the defendant DAVID CARPENTER as a further payment of WINANS' share of the proceeds of the scheme. On or about the following day, the check was deposited to a joint checking account maintained by WINANS and CARPENTER.

31. In or about mid-January, 1984, Peter N. Brant advised the defendant R. FOSTER WINANS in substance that losses due to a recent price drop in the stock of Digital Switch Corp., a stock in which Brant was heavily invested, were restricting the ability of the conspirators to conduct further trading. Brant further advised WINANS that if he were able to sell his Digital Switch stock at a favorable price, the conspirators' volume of trading could increase. Brant also suggested to WINANS the basis for a favorable story about Digital Switch. On January 19, 1984, WINANS caused to be published a favorable "Heard on the Street" column concerning Digital Switch. Later on the same day, Brant caused 25,000 shares of Digital Switch to be sold at an average price of approximately $32 per share from two accounts which were maintained at Kidder Peabody in the name of a customer and in which Brant had a profit-sharing interest. These sales after publication of WINANS' article resulted in a profit of approximately $11,250 over the previous day's closing price for Digital Switch.

32. On or about January 29, 1984, the defendant KENNETH P. FELIS wrote a $10,000 check payable to the defendant DAVID CARPENTER, which Peter N. Brant subsequently delivered to the defendant R. FOSTER WINANS as a further payment in connection with the scheme. Pursuant to an understanding among the conspirators, the word "drapes" was noted on the check in order to support the false explanation that the

payment was in return for interior decorating services rendered by CARPENTER.

33. At approximately 4:40 p.m. on Thursday, March 1, 1984, the defendant R. FOSTER WINANS was interviewed by telephone by staff members of the Securities and Exchange Commission.

34. Later on or about Thursday, March 1, 1984, the defendant DAVID CARPENTER, acting as a "go-between" for the defendant R. FOSTER WINANS, telephoned Peter N. Brant and in a coded conversation asked to meet with Brant. CARPENTER and Brant met later the same night at Brant's Manhattan apartment and discussed the SEC's questions and WINANS' responses as well as the false explanation for the checks payable to CARPENTER in return for "decorating services."

35. Beginning on or about Saturday, march 3, 1984 and on a number of occasions over the next two and one-half weeks, the defendant DAVID CARPENTER met with Peter N. Brant and occasionally with the defendant KENNETH P. FELIS at Brant's home on Long Island, at Brant's apartment in Manhattan, and at a number of other locations in Manhattan, to discuss the course of the investigation, the false invoices for "decorating services" to account for the payments from Brant and FELIS. On or about March 22, 1984, CARPENTER delivered three such invoices to Brant and FELIS.

36. On or about the evening of Wednesday, March 21, 1984, the defendants R. FOSTER WINANS, KENNETH P. FELIS and DAVID CARPENTER and Peter N. Brant met at Trader Vic's at the Plaza Hotel in Manhattan to review the course of the SEC investigation and the false cover story.

OVERT ACTS

In furtherance of the conspiracy and to effect its objects, the following overt acts, among others, were committed in the Southern District of New York:

37(a)-37(v). On or about the day before each "date of publication" in each of the overt acts (a) through (v) below, the defendant R. FOSTER WINANS wrote or contributed to "Heard on the Street" columns or other articles concerning the "subject" listed:

	DATE OF PUBLICATION	SUBJECT
(a)	1/13/83	American Surgery Centers Corp.
(b)	3/23/83	American Surgery Centers Corp.
(c)	6/1/83	Institutional Investors Corp.
(d)	10/19/83	Schlumberger Ltd.
(e)	10/20/83	TIE/Communications, Inc.
(f)	10/21/83	Merrill Lynch & Co.
(g)	10/25/83	Key Pharmaceuticals, Inc.
(h)	10/28/83	Todd Shipyards Corp.
(i)	10/31/83	Charter Co.
(j)	11/1/83	Toys "R" Us, Inc.
(k)	11/2/83	International Paper Co.
(l)	11/9/83	Western Union Corp.
(m)	11/17/83	Coleco Industries Inc.
(n)	12/6/83	Petro-Lewis Corp.
(o)	12/12/83	G.D. Searle & Co.
(p)	2/3/84	Merrill Lynch & Co.
(q)	2/14/84	Quotron Systems Inc.

	DATE OF PUBLICATION	SUBJECT
(r)	2/15/84	Isomedix, Inc.
(s)	2/15/84	Radiation Technology, Inc.
(t)	2/17/84	Beatrice Foods Co.
(u)	2/22/84	Kaypro Corp.
(v)	2/27/84	Chicago Milwaukee Corp.

(Title 18, United States Code, Section 071.)

COUNTS TWO THROUGH TWENTY-FIVE

The Grand Jury further charges:

38. On or about the dates indicated in Counts Two through Twenty-Five below, in the Southern District of New York, the defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS as indicated in the "Defendants Charged" column below and with respect to the counts in which their names are listed, unlawfully, wilfully and knowingly, directly and indirectly, and by use of means and instrumentalities of foreign and interstate commerce, the mails, and the facilities of national securities exchanges, did (a) employ devices, schemes, and artifices to defraud, and (b) engage in acts, practices and courses of business, which operated as a fraud and deceit on the Wall Street Journal and Dow Jones & Company, Inc., in connection with the purchase and sale of securities, including the following:

COUNT	SUBJECT COMPANY	APPROX-IMATE DATE OF TRANSAC TIONS	NUMBER OF SHARES/ OPTIONS BOUGHT (SOLD)	DEFENDANTS CHARGED
2	Schlumberger, Ltd.	10/17/83	15,000 Shares 100 Calls	Winans/Felis
3	TIE/Communications, Inc.	10/19/83	454 Puts	Winans/Felis
4	Merrill Lynch & Co., Inc.	10/20/83	543 Puts	Winans/Felis
5	Key Pharmaceuticals, Inc.	10/24/83	232 Puts	Winans/Felis
6	International Harvester Co.	10/25/83	20,000 Shares	Winans/Felis
7	Commodore/International Ltd.	10/27/83	000 Puts	Winans/Felis
8	Todd Shipyards Corp.	10/27/83	5,000 Shares	Winans/Felis
9	Charter Co.	10/27/83	346 Puts	Winans/Felis
10	Toys "R" Us, Inc.	10/31/83	15,000 Shares	Winans/Felis
11	International Paper Co.	11/1/83	(10,000 Shares) 100 Puts	Winans/Felis
12	Perkin-Elmer Corp.	11/2/83	20,000 Shares 8 Calls	Winans/Felis
13	Petro-Lewis Corp.	12/1/83	25,000 Shares	Winans/Felis
14	Rolor Corp.	12/2/83	20 Puts	Winans/Carpenter
15	G. D. Searle & Co.	12/9/83	82 Puts 20 Puts	Winans/Felis
16	Greyhound Corp.	12/9/83	522 Calls	Winans/Felis
17	Greyhound Corp.	12/9/83	15 Calls	Winans/Carpenter
18	Merrill Lynch & Co., Inc.	2/2/84	15 Puts	Winans/Carpenter
19	Quotron Systems, Inc.	2/3/84	(10,000 Shares)	Winans/Felis
20	Quotron Systems, Inc.	2/10/84- 2//11/84	(1,500 Shares)	Winans/Felis
21	Browning-Ferris Industries, Inc.	2/14/84	3 Puts	Winans/Carpenter
22	Beatrice Foods Co.	2/16/84	15 Calls	Winans/Carpenter
23	Beatrice Foods Co.	2/16/84	40 Calls	Winans/Felis
24	Kaypro Corp.	2/21/84	200 Shares	Winans/Carpenter

COUNT	SUBJECT COMPANY	APPROX-IMATE DATE OF TRANSAC TIONS	NUMBER OF SHARES/ OPTIONS BOUGHT (SOLD)	DEFENDANTS CHARGED
25	Chicago Milwaukee Corp.	2/16/84	800 Shares	Winans/Felis

39. The allegations contained in all the preceding paragraphs of Count One of this Indictment are repeated and realleged as though fully set forth herein and as constituting and describing part of the scheme by which the defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS committed the offenses charged in Counts Two through Twenty-Five.

(Title 15, United States Code, Sections 78j(b) and 78ff, Rule 10b-5 [17 C.F.R. § 240.10b-5] and Title 18, United States Code, Section 2).

COUNTS TWENTY-SIX THROUGH

FORTY-THREE

The Grand Jury further charges:

40. From on or about January 1, 1983, up to and including March 29, 1984, in the Southern District of New York and elsewhere, R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS, the defendants and others to the Grand Jury known and unknown, did unlawfully, wilfully and knowingly devise and intend to devise a scheme and artifice to defraud and to obtain money by means of false and fraudulent pretenses, representations, and promises as alleged in paragraphs one through thirty-six above.

41. On or about the day before the "Date of Publication" set forth below, in the Southern District of New York, R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS, the defendants, as indicated below in the "Defendants Charged" column and with respect to the counts below in which their names are listed, unlawfully, wilfully and knowingly, for the purpose of executing said

scheme and artifice did cause to be transmitted by means of wire and radio and television communication in interstate commerce writings, signs and signals; to wit, "Heard on the Street" columns or other articles written in whole or in part by WINANS concerning the "subject(s)" set forth below, transmitted from the Wall Street Journal at 22 Cortlandt Street, New York, New York, to Chicopee, Massachusetts, for printing and re-transmission by satellite:

COUNT	DATE OF PUBLI-CATION	SUBJECTS	DEFENDANTS CHARGED
26	10/19/83	Schlumberger, Ltd.	Winans/Felis
27	10/20/83	TIE/Communications, Inc.	Winans/Felis
28	10/21/83	Merrill Lynch & Co.	
29	10/23/83	Key Pharmaceuticals, Inc.	Winans/Felis
30	10/28/83	Todd Shipyards Corp.	Winans/Felis
31	10/31/83	Charter Co.	Winans/Felis
32	11/1/83	Toys "R" Us, Inc.	Winans/Felis
33	11/2/83	International Paper Co.	Winans/Felis
34	11/8/83	Western Union Corp.	Winans
35	11/17/83	Coleco Industries, Inc.	Winans
36	12/6/83	Petro-Lewis Corp.	Winans/Felis
37	12/12/83	G. D. Searle & Co.	Winans/Felis
38	2/3/84	Merrill Lynch & Co.	Winans/Carpenter
39	2/14/84	Quotron Systems, Inc.	Winans/Felis
40	2/15/84	Isomedix, Inc.	Winans/Carpenter/Felis
		Radiation Technology, Inc.	
41	2/17/84	Beatrice Foods Co.	Winans/Carpenter/Felis
42	2/22/84	Kaypro Corp.	Winans/Carpenter

COUNT	DATE OF PUBLI-CATION	SUBJECTS	DEFENDANTS CHARGED
43	2/27/84	Chicago Milwaukee Corp.	Winans/Felis

42. The allegations contained in all the preceding paragraphs of Count One of this Indictment are repeated and realleged as though fully set forth herein and as constituting and describing part of the scheme by which the defendants R. FOSTER WINANS, DAVID CARPENTER and KENNETH P. FELIS and others committed the offenses charged in these counts.

(Title 18, United States Code, Sections 1343 and 2.)

45. The allegations contained in all the preceding paragraphs of Count One of this Indictment are repeated and realleged as though fully set forth herein and as constituting and describing part of the scheme by which the defendants R. FOSTER WINANS, DAVID CARPENTER, and KENNETH P. FELIS committed the offenses charged in these Counts.

(Title 18, United States Code, Sections 1341 and 2.)

FOREMAN

WILLIAM M. TENDY
Acting United States
Attorney

EXH. W-D

CHART OF INDICTMENT CHARGES RELATED TO DAVID CARPENTER SCHWAB ACCOUNT TRANSACTIONS

Count	Security	Date, Type and Price of Purchase	Date of WJS Articles	Date and Price of Sale	Profit
14	Roton Corp.	12/2/8320 Dec. 50 puts $ 690.00	12/5/83	12/5/83 20 Dec. 50 puts $1,434.95	$744.95
17	Greyhound Corp.	12/9/8315 Jan. 25 calls $ 992.50	12/13/83	12/13/83 15 Jan. 25 calls $2,379.91	$1,387.41
18	Merrill Lynch	2/2/84 15 Apr. 25 puts $ 617.50	2/3/84	2/3/84 15 Apr. 25 puts $ 788.72	$171.22
56					
21	Browning-Ferris	2/14/84 3 Mar. 35 puts $ 691.25	2/15/84	2/15/84 5 Mar. 35 puts $ 963.96	$272.71
22	Beatrice Foods	2/16/84	2/16/84 &	2/17/84	
43			2/17/84		
59		15 Mar. 13 calls $1,086.25		15 Mar. 35 calls $2,658.90	$1,372.65
24	Hypro Corp.	2/21/84 200 shs. common	2/22/84	2/24/84 700 shs. common	
60		$1,283.00		$1,636.90	$ 353.30
					$4,502.84

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Supreme Court, U.S.
FILED
APR 9 1997
CLERK

(13)

No. 96-842

In the Supreme Court of the United States

OCTOBER TERM, 1996

UNITED STATES OF AMERICA, PETITIONER

v.

JAMES HERMAN O'HAGAN

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

WALTER DELLINGER
Acting Solicitor General
Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

24 pp

TABLE OF AUTHORITIES

Cases:	Page
Basic Inc. v. *Levinson*, 485 U.S. 224 (1988)	5
Bateman, Eichler, Hill Richards, Inc. v. *Berner*, 472 U.S. 299 (1985)	11
Blue Chip Stamps v. *Manor Drug Stores*, 421 U.S. 723 (1975)	5
Boyce Motor Lines, Inc. v. *United States*, 342 U.S. 337 (1952)	13
Cady, Roberts & Co., In re, 40 S.E.C. 907 (1961)	15
Carpenter v. *United States*, 484 U.S. 19 (1987)	14, 18
Chevron U.S.A. Inc. v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984)	17
Chiarella v. *United States*, 445 U.S. 222 (1980)	10, 11, 13, 14, 18
Dirks v. *SEC*, 463 U.S. 646 (1983)	11, 14
Dobbert v. *Florida*, 431 U.S. 282 (1977)	
Ford v. *United States*, 273 U.S. 593 (1927)	19
Green v. *Santa Fe Industries*, 533 F.2d 1309 (2d Cir. 1976), rev'd, 430 U.S. 462 (1977)	8
Herman & MacLean v. *Huddleston*, 459 U.S. 375 (1983)	5
Lewis v. *McGraw*, 619 F.2d 192 (2d Cir.), cert. denied, 449 U.S. 951 (1980)	17
O'Neill v. *Maytag*, 339 F.2d 764 (2d Cir. 1964)	8
Santa Fe Industries v. *Green*, 430 U.S. 462 (1977)	6
Schreiber v. *Burlington Northern, Inc.*, 472 U.S. 1 (1985)	16
Screws v. *United States*, 325 U.S. 91 (1945)	13
Superintendent of Insurance v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971)	10
United States v. *Charnay*, 537 F.2d 341 (9th Cir.), cert. denied, 429 U.S. 1000 (1976)	13

Cases—Continued: Page

United States v. *Chestman*, 947 F.2d 551 (2d Cir. 1991), cert. denied, 503 U.S. 1004 (1992) 14, 16
United States v. *Dixon*, 536 F.2d 1388 (2d Cir. 1976) 13
United States v. *Lang*, 766 F. Supp. 389 (D. Md. 1991) 15
United States v. *Lanier*, No. 95-1717 (Mar. 31, 1997) 15, 18
United States v. *Miller*, 471 U.S. 130 (1985) 19
United States v. *Naftalin*, 441 U.S. 768 (1979) 10, 11
United States v. *Newman*, 664 F.2d 12 (1981), aff'd after remand, 722 F.2d 729 (2d Cir.), cert. denied, 464 U.S. 863 (1983) 15
United States v. *Peltz*, 433 F.2d 48 (2d Cir. 1970), cert. denied, 401 U.S. 955 (1971) 13
United States v. *Ragen*, 314 U.S. 513 (1942) 13
United States v. *United States Gypsum Co.*, 438 U.S. 442 (1980) 13, 18
United States v. *Yermian*, 468 U.S. 63 (1984) 4, 18
Village of Hoffman Estates v. *The Flipside, Hoffman Estates, Inc.*, 455 U.S. 489 (1982) 13

Statutes and regulations:

Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4788 .... 12, 15
Securities Act of 1933, 15 U.S.C. 77a *et seq.*:
§ 17(a)(1), 15 U.S.C. 77q(a)(1) 10
§ 32(a), 15 U.S.C. 78ff(a) 12
Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq.*:
§ 10(b), 15 U.S.C. 78j(b) 4, 5, 9, 10, 11, 12, 19
§ 14(e), 15 U.S.C. 78n(e) 2, 15, 16, 17
§ 16(b), 15 U.S.C. 78p(b) 15
Williams Act, Pub. L. No. 90-439, § 3, 82 Stat. 457 ... 16, 17
17 C.F.R.:
Section 240.10b-5 (Rule 10b-5) 20
Section 240.14e-3 (Rule 14a-3) 18

Regulation—Continued: Page

Section 240.14e-3(a) (Rule 14a-3(a)) 15, 18

Miscellaneous:

Ann M. Hart, *The* Model Rules *Are Close and the* Restatement *Is Closer*, 10 Geo. J. Legal Ethics 192 (1996) 14
H.R. Rep. No. 910, 100th Cong., 2d Sess. (1988) 12, 15
Adam Ingber, *10b or Not 10b-5?: Are the Current Efforts to Reform Securities Litigation Misguided?*, 61 Fordham L. Rev. S35.1 (1993) 5
Louis Loss & Joel Seligman, *Securities Regulation* (3d ed. 1989) 5
Restatement (Second) of Agency (1958) 4, 6
Restatement (Second) of Torts (1959) 5
Restatement (Second) of Trusts (1977) 7
Restatement (Third) of the Law Governing Lawyers:
Preliminary Draft No. 2 (1967) 14
Tentative Draft No. 3 (1990) 14
Proposed Final Draft No. 1 (1996) 14

In the Supreme Court of the United States

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No. 96-842

UNITED STATES OF AMERICA, PETITIONER

v.

JAMES HERMAN O'HAGAN

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

---

1. Respondent argues that his trading in securities on misappropriated confidential information did not violate the federal securities laws. He begins by attacking the factual underpinning of the jury's verdict, which found that he engaged in that form of deception in connection with his securities trading. The jury correctly resolved the factual issues against him.

Respondent first asserts (Br. 3) that, with the exception of one order for 5,000 shares of Pillsbury stock, all his orders for Pillsbury securities were placed with his brokers before August 26, 1988—the date on which partners at Dorsey & Whitney (Dorsey) met to discuss whether to continue their representation of Grand Metropolitan PLC (Grand Met) in its attempt to acquire Pillsbury, and the earliest date, according to respondent (Br. 2), on which he could have confirmed the nonpublic information that a

takeover of Pillsbury was being planned. The jury correctly rejected that contention. The jury was instructed, on the Section 10(b) counts, that "[t]he government must prove beyond a reasonable doubt that the defendant used the material, nonpublic information * * * when he purchased the Pillsbury securities." J.A. 200. It was also instructed, on the Section 14(e) counts, that illegal insider trading with respect to tender offers exists only when "the defendant, knowing that this information came from the corporation, invests in securities using material nonpublic information." J.A. 203. While respondent suggests that he traded on publicly reported news stories rather than material, nonpublic information (Br. 4), the jury was expressly instructed on the difference between public and nonpublic information, see J.A. 198-199, and it rejected that contention. The jury found instead that respondent "used" material, nonpublic information in his trading. That finding, which is supported by the record, is inconsistent with respondent's claim that he placed all of his options orders before he learned nonpublic information about the Pillsbury takeover.[1]

---

[1] Respondent begins from the erroneous premise (Br. 3 n.6) that he could not have had nonpublic information before August 26, 1988, and argues that trades before that date were therefore lawful. Thomas Tinkham testified, however, that respondent spoke to him "a few days before" August 26, and that respondent knew by then that the firm "was doing work on a takeover of the Pillsbury company." J.A. 128-129. Respondent obtained the money for his options purchases by executing a mortgage on his home on August 24, 1988; he issued a $200,000 check to the brokerage firm of Robinson Humphrey on August 29, by drawing on a line of credit secured by the mortgage. V Tr. 168; VI Tr. 121-122. That evidence indicates that respondent had nonpublic information about the Pillsbury takeover by August 24 at the latest.

As to the timing of his orders, respondent relies largely (Resp. Br. 3 n.6) on his testimony to the SEC during its investigation. The jury was entitled to discredit those self-serving claims. Even that testimony shows only that respondent told the SEC that he thought he authorized one of his brokers, Steuart Evans, to purchase 500 October 40 options on August 25, but that Evans misunderstood the order to be for 2,000 October 40 options. Moreover, according to respondent's SEC testimony, he learned about Evans' "misunderstanding" on September 7 but agreed to continue purchasing the options to fill out the order for the 2,000 options. J.A. 47-49, 53-54; 12/21/88 Tr. 158-164, 168-172, 176-178, 182-183. That testimony undermines any suggestion that respondent did not make investment decisions (and purchases) after August 26.

Respondent's argument also does not account for another 400 options purchased through Evans or for 100 options purchased through Patricia Kinnahan (his Janney Montgomery Scott broker) that are charged in the indictment. Respondent testified during the SEC investigation that he placed an order for 500 November options with Evans on September 18 (after respondent returned from a honeymoon in Europe). Pursuant to that order, Evans also purchased 100 October 45 options on September 20. Respondent told the SEC that he canceled the order on September 22 after learning the preceding day that Dorsey & Whitney had been involved in the Pillsbury takeover. 12/21/88 Tr. 186-191, 193-197, 204-206, 212-213, 219-224, 255-257. Kinnahan testified at trial that she purchased 100 options charged in the indictment for respondent based on an order placed on August 19, 1988. VII Tr. 108, 112, 163-164. Kinnahan purchased 50 November (she said October) 45 options on August 30, 1988, and 50 November 45 options on September 8, 1988. VII Tr. 108, 112-118. In her June 15, 1989, affidavit to the SEC, however, Kinnahan stated that respondent authorized those purchases when she called him on those two dates. Kinnahan later changed her mind and said, in a second affidavit dated June 24, 1998 (after the indictment was returned), that respondent placed the orders on August 19, 1988. VII Tr. 139-143, 154-158, 163. Given the conflicting affidavits and other testimony, the jury was entitled to disbelieve respondent's evidence and conclude that he had placed the orders charged in the indictment when in possession of nonpublic information confirming Dorsey's representation of a client in a planned takeover of Pillsbury.

Respondent maintains (Br. 5) that the evidence showed only that an undisclosed client had retained Dorsey with respect to a potential takeover of Pillsbury. Respondent does not argue, however, that he owed no fiduciary duty to that client (or to Dorsey) solely because he did not know

the client's name. Respondent knew that Dorsey had been engaged to represent a company in "a takeover of the Pillsbury company," J.A. 129, and he traded on the basis of that confidential information. It is irrelevant that Dorsey's formal client files did not reflect the details of the firm's representation, so that some Dorsey employees would have been unaware of the firm's representation of a client in matters related to a takeover of Pillsbury (see Resp. Br. 1 n.1; J.A. 122). Respondent was aware of that representation, and he therefore had a fiduciary obligation to the firm's client not to convert its information to his own benefit. He also had a similar obligation to his partners. See generally Restatement (Second) of Agency § 431 (1958).

2. a. In arguing that his conduct did not constitute a "deceptive device or contrivance" in violation of Section 10(b), respondent does not dispute that conduct like his has long been held to be *fraudulent*. Nor does he dispute that this Court's decision in *Carpenter* v. *United States*, 484 U.S. 19, 27-28 (1987), holds that a fiduciary's misappropriation of his principal's confidential business information is fraudulent. Instead, respondent argues (Br. 17 & n.19) that his conduct was not *deceptive*. There is no basis, however, for respondent's suggestion that "decept[ion]," as used in the text of Section 10(b), defines a class of acts *narrower* than fraud. To the contrary, a course of conduct that is fraudulent is also deceptive, for the concept of fraud inherently includes deception. "Deceive is to cause to believe the false or to mislead. Defraud is to deprive of some right, interest or property *by deceit*." *United States* v. *Yermian*, 468 U.S. 63, 73 n.12 (1984) (emphasis added).

To narrow the reach of the words "deceptive device," respondent asserts that Section 10(b)'s proscription of deception is limited to the common law tort of deceit. Resp. Br. 15-16. Even if that were true, it would not help respondent. He suggests that the common law tort of

deceit requires an express misrepresentation or nondisclosure, rather than deceptive conduct, and requires proof of reliance. Under the Restatement (Second) of Torts § 525, cmt. b (1977), however, "'[m]isrepresentation' * * * denote[s] not only words spoken or written but also any other conduct that amounts to an assertion not in accordance with the truth." Respondent's conduct misled Dorsey and Grand Met into believing that he was a loyal employee, and he failed to make required disclosures to his principals, to their detriment. See pp. 6-7, 9, *infra*.

In any event, this Court has made clear that "[a]ctions under Rule 10b-5 are distinct from common-law deceit and misrepresentation claims, and are in part designed to add to the protections provided investors by the common law." *Basic Inc.* v. *Levinson*, 485 U.S. 224, 244 n.22 (1988) (citation omitted); see also *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 388-389 (1983) ("the antifraud provisions of the securities laws are not coextensive with common-law doctrines of fraud"); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 744-745 (1975) ("the typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable").[2]

Respondent also argues (Br. 19) that the misappropriation theory of liability under Section 10(b) is inconsistent with *Santa Fe Industries* v. *Green*, 430 U.S. 462 (1977), which holds that a mere breach of fiduciary duty, without deception, does not violate Section 10(b). Respondent

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[2] See generally Louis Loss & Joel Seligman, *Securities Regulation* 3429-3430 (3d ed. 1989) ("courts have repeatedly said that the fraud provisions in the SEC Acts * * * are not limited to circumstances that would give rise to a common law action for deceit"); Adam Ingber, *10b-5 or Not 10b-5?: Are the Current Efforts to Reform Securities Litigation Misguided?*, 61 Fordham L. Rev. S351, S380 n.147 (1993) (summarizing differences between common law fraud actions and antifraud provisions of federal securities law).

suggests that, under the misappropriation theory, even the *Santa Fe* defendants would be found to have engaged in deception by impliedly misrepresenting that they were acting honestly and in the best interests of the business, and yet the Court found in that case that there was no deception. Respondent argues that the Court in *Santa Fe* must have rejected the view that an implied misrepresentation in a breach of fiduciary duty is a deceptive device. Resp. Br. 19. *Santa Fe*, however, is not inconsistent with the misappropriation theory.

Contrary to respondent's claim (Br. 19), the misappropriation theory does not posit that every breach of a fiduciary duty necessarily entails deception. Rather, liability under the misappropriation theory is premised on the fact that the particular breach of duty involved in the conversion of confidential information that has been entrusted to one for a limited purpose inherently involves deception. Thus, under well settled principles, before an agent may use his principal's confidential business information for his personal benefit, he must make disclosure to the principal and obtain the principal's consent; the breach of that duty thus inherently involves deceptive nondisclosure.[3]

[3] The common law rule requiring an agent to make disclosure to his principal before trading on information belonging to the principal is well established:

> § 395 Using or disclosing confidential information
>
> *Unless otherwise agreed*, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as an agent, in competition with or to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is a matter of general knowledge.

Restatement (Second) of Agency § 395 (1958) (emphasis added). By requiring that the principal and agent agree to any use of the principal's information by the agent, the Restatement makes clear that disclosure to the principal is required. See *id.* cmt. e ("In obtaining consent of the principal to use or disclose confidential information, the agent is under the duty of disclosure stated in Section 390."). See also *id.* § 390 (agent, when acting on his own account in a matter in which the principal is interested, must "disclose to [the principal] all facts which the agent knows or should know would reasonably affect the principal's judgment"), cmt. a ("an agent has a duty, not only to make no misstatements of fact, but also to disclose to the principal all relevant facts fully and completely," including "the fact that the agent is acting on his own account"); *id.* § 381, cmt. d ("If the agent * * * is competing with the principal and using information acquired during his agency, he is under a duty to the principal to reveal such facts in accordance with the rules stated in Sections 389-392.").

Trustees have similar obligations to obtain the consent of, and furnish information to, their beneficiaries, and a trustee's breach of those obligations rests on nondisclosure.[4] In this case, therefore, it is respondent's failure to disclose his personal trading to Grand Met and Dorsey, in breach of his duty to do so, that makes his conduct "deceptive" within the meaning of Section 10(b).[5]

[4] See Restatement (Second) of Trusts § 170(2) (1959) (trustee dealing with beneficiary on his own account must disclose all material facts), *id.* cmt. a (trustee may not profit at the expense of, or compete with, beneficiary, without consent or authorization under the terms of the trust), *id.* § 173 cmt. d (trustee must disclose material facts that the beneficiary does not know but needs to know for his protection in dealing with a third person with respect to his interest).

[5] It is in that sense that here, as in *Carpenter*, the agent's posing as a loyal employee constitutes deception. Respondent's pose also went beyond silence, in breach of his duty to disclose his personal trading. He engaged in deception in his conversation with Thomas Tinkham by feigning an interest in working on the Pillsbury takeover litigation. Respondent erroneously states (Br. 20) that the record does not show such feigning, and that the government has not previously made that contention. Tinkham testified that he thought that respondent's request to work for him was unusual because respondent was senior to him in the firm's hierarchy, J.A. 131, thus implying that respondent had an ulterior motive. The government argued to the jury that

The particular nature of the duty breached by respondent distinguishes this case from *Santa Fe*, where the complaint alleged "a breach by the majority of its fiduciary duty to deal fairly with the minority" by undervaluing the minority's stock in a short-form merger. *Green* v. *Santa Fe Industries*, 533 F.2d 1283, 1285 (2d Cir. 1976), rev'd, 430 U.S. 462 (1977). Deception was not necessary to breach the duty of fairness there, and there was no suggestion that the majority had a fiduciary duty to accuse itself of financial unfairness after having fully disclosed the terms of the merger. As the Second Circuit recognized in *O'Neill* v. *Maytag*, 339 F.2d 764, 767 (1964),

> [b]etween principal and agent and among corporate officers, directors and shareholders, state law has created duties which exist independently of the sale of stock. While the essence of these duties in some circumstances is honest disclosure, * * * [other cases] are typical of situations in which deception may be immaterial to a breach of duties imposed under common law principles.

Santa Fe involved an alleged breach of duty in which deception was "immaterial." 553 F.2d at 1285. This case, in contrast, presents a situation in which the "essence" of the agent's duty requires "honest disclosure." *Ibid.*

The jury in this case was instructed accordingly. The court charged, without objection, that "[u]nless otherwise agreed, an agent has a duty to the principal not to use or to communicate information confidentially obtained by him

---

respondent "confirm[ed] the information he somehow learned [about the Pillsbury takeover] by approaching Tom Tinkham in his office and engaging Tom Tinkham in conversation." XI Tr. 74. The government also argued to the court of appeals that respondent had "feigned an interest in working on the case," and had "masqueraded as a loyal, trustworthy partner for the purpose of drawing information out of Tinkham." Gov't C.A. Br. 8, 49.

from the principal." J.A. 197. Respondent breached that duty by failing to disclose to Dorsey and Grand Met that he planned to buy Pillsbury securities on confidential client information and failing to obtain their agreement to that plan. His use of the information, resulting from that breach, constituted deception. And, contrary to respondent's claim (Br. 19), his deception lulled his principals into inaction that worked to their detriment. Respondent's pose of loyalty deprived Grand Met and Dorsey of the opportunity to protect Grand Met's exclusive right to use its confidential business information, thus jeopardizing interests of both Grand Met and Dorsey.[6]

There is no merit to respondent's claim (Br. 20-21) that the Section 10(b) convictions cannot stand because the indictment did not charge him with deception, and because the jury was not expressly instructed that it had to find "deception." In fact, the indictment did charge deception.[7]

---

[6] Thomas Tinkham testified that, if respondent had disclosed that he was trading in Pillsbury securities during September, Tinkham would have considered it to be "a very significant problem for the firm and an enormous breach of trust." V Tr. 99 (Resp. Br. in Opp. App. 17a). Tinkham explained: "[A]s lawyers representing a client, we have an obligation not to use information from that client for our own benefit." V Tr. 100 (Resp. Br. in Opp. App. 17a-18a). Tinkham testified that had he known about the trading, "I would have been more than a little upset." *Ibid.* See also J.A. 102-103 (testimony of Alan Parker that Cravath, Swaine & Moore, as Grand Met's lawyers, "had a legal obligation to insure that the information would not fall into the hands of people who would appropriate it for improper use," and explaining that leaks or misuse of takeover plans would harm Grand Met by driving up price of Pillsbury shares).

[7] The indictment expressly charged that respondent "did use and employ manipulative and deceptive devices and contrivances in connection with the purchase and sale of securities" (J.A. 16), and did "engage in acts, practices and courses of business which would and did operate as a fraud and deceit upon Grand Met and Dorsey and Whitney" (J.A. 17).

And the conduct described in the instructions (J.A. 195-198) and found by the jury—use of a principal's confidential information without the principal's agreement—is inherently a form of deception, just as under the classical theory of insider trading, an insider's trading in his corporation's own securities in breach of a duty to disclose or abstain is inherently deceptive. Cf. *Chiarella* v. *United States*, 445 U.S. 222, 230 (1980).

b. In contending that his conduct was not "in connection with" the purchase or sale of a security within the meaning of Section 10(b), respondent argues that the statute prohibits only fraud "between parties to a securities transaction" (Br. 23), or fraud "on a participant in a securities transaction" (Br. 24 n.27 (emphasis omitted)). Those limitations are not found in the statutory language and conflict with this Court's cases.

Respondent's assertion (Br. 28) that Section 10(b) contains a "textual requirement that deception * * * occur between parties to a securities transaction" cannot be reconciled with *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971). There, a corporation's insiders defrauded the corporation by directing it to sell the corporation's Treasury bonds and then misappropriating the proceeds of the completed sale. The Court found that fraud to be "in connection with" the sale of the bonds, even though there was no fraud *between* the parties to the transaction, *i.e.*, the buyer of the bonds committed no misconduct. *Id.* at 9-10. Nor is there merit to respondent's "participant" test (see Resp. Br. 24 n.27). In *United States* v. *Naftalin*, 441 U.S. 768 (1979), the Court held that Section 17(a)(1) of the Securities Act of 1933, 15 U.S.C. 77q(a)(1), which prohibits fraud "in the offer or sale of securities," is not limited to fraud perpetrated on participants in a securities transaction. The Court stressed there that the antifraud provisions of the securities laws are not limited to the protection of investors, but extend to "frauds perpetrated upon *either business or* investors." 441 U.S. at 776 (emphasis added).[8]

Bankers Life and *Naftalin* demonstrate that Congress used the phrase "in connection with" in its ordinary meaning, as "related to" or "involving." Respondent's fraud was "in connection with" his purchases of Pillsbury securities because, as in *Bankers Life*, his trades were a necessary element of his fraud. The nonpublic information about the Pillsbury takeover had no value to respondent personally except as it might enable him to reap windfall profits in the securities market (or enable someone else to reap such profits, through illegal tipping). Thus, contrary to respondent's assertion (Br. 23), his deceptive fiduciary breach and his purchase of securities were connected, because the breach was consummated *by* his purchase of securities.

Respondent suggests (Br. 24) that by prohibiting frauds on the source of information used for securities trading,

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[8] Respondent relies (Br. 25-26) on passages from this Court's opinions in *Chiarella* v. *United States*, 445 U.S. 222, 230 (1980), where the Court stated that liability under Section 10(b) "is premised on a duty to disclose arising from a relationship of trust and confidence between parties to a transaction," and *Dirks* v. *SEC*, 463 U.S. 646, 663 n.23 (1983), where the Court noted that Section 10(b) prohibits "intentional or willful conduct designed to deceive or defraud investors." Those passages, however, merely reflect the nature of the facts and legal claims made in those cases; they were not intended to resolve the question of liability under Section 10(b) in cases like this one, where deception is practiced on the source of the material, nonpublic information used in securities trading but not on a party on the other side of the trade. The Court expressly reserved the validity of the misappropriation theory in both cases. See *Dirks*, 463 U.S. at 665 ("Nor did Dirks misappropriate or illegally obtain the information."); *Chiarella*, 445 U.S. at 236-237. See also *Bateman, Eichler, Hill Richards, Inc.* v. *Berner*, 472 U.S. 299, 313 n.22 (1985) ("We have also noted that a tippee may be liable if he otherwise 'misappropriate[s] or illegally obtain[s] the information.'") (citing *Dirks*, 463 U.S. at 665).

the misappropriation theory departs from the concern of the securities laws to protect investors. That is incorrect. No less than classical insider trading, trading on misappropriated information damages capital markets and diminishes the public's faith in honest securities markets. As the House Report noted when the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), Pub. L. No. 100-704, 102 Stat. 4788, was enacted, "the small investor will be—and has been—reluctant to invest in the market if he feels it is rigged against him." H.R. Rep. No. 910, 100th Cong., 2d Sess. 8 (1988). If investors believed that the securities markets were characterized by trading on misappropriated information, and that they could not look to the securities laws and the SEC for protection from such overreaching, the liquidity of those markets and capital formation would suffer. That result would injure the public interest that the SEC is charged with protecting under Section 10(b).

c. Respondent also argues (Br. 30-33) that application of the misappropriation theory raises serious questions of due process, because, he maintains, the theory provides insufficient guidance as to the conduct that is criminal. That argument is without merit.

First, to establish a criminal violation of Section 10(b), the government must show that a person violated that provision "willfully." 15 U.S.C. 78ff(a).[9] To act willfully, the defendant must realize that he is committing a wrongful

[9] 15 U.S.C. 78ff(a) states in relevant part: "Any person who willfully violates any provision of this chapter * * * or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter * * * shall upon conviction be fined to not more than $1,000,000, or imprisoned not more than 10 years, or both * * * ; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation."

act. See *United States* v. *Charnay*, 537 F.2d 341, 352 (9th Cir. 1976); *United States* v. *Dixon*, 536 F.2d 1388, 1397 (2d Cir. 1976); *United States* v. *Peltz*, 433 F.2d 48, 54-55 (2d Cir. 1970), cert. denied, 401 U.S. 955 (1971). Because the government must prove consciousness of wrongdoing, "the accused cannot be said to suffer from lack of warning or knowledge that the act which he does is a violation of the law." *Screws* v. *United States*, 325 U.S. 91, 102 (1945) (plurality opinion). "This requirement of the presence of culpable intent as a necessary element of the offense does much to destroy any force in the argument that application of the [Act]" in these circumstances would be unfair. *Boyce Motor Lines, Inc.* v. *United States*, 342 U.S. 337, 342 (1952); see also *Village of Hoffman Estates* v. *The Flipside, Hoffman Estates, Inc.*, 455 U.S. 489, 499, 502 (1982); *United States* v. *United States Gypsum Co.*, 438 U.S. 422, 445 (1978); *United States* v. *Ragen*, 314 U.S. 513, 524 (1942).

Second, the misappropriation theory is not impermissibly indefinite because it involves proof of a breach of a fiduciary or similar duty of trust and confidence. The classical insider trading theory requires courts to consider whether the trader was under a fiduciary or similar duty creating an obligation to disclose or abstain from trading, and the types of relationships considered in that context are often comparable to the relationships at issue in this case.[10] The misappropriation theory extends only

[10] As this Court has made clear, the obligation to disclose or abstain from trading on material, nonpublic information rests on a legal duty of trust and confidence, and the courts must consider in each case whether the defendant charged with illegal trading had a legal duty not to take unfair advantage of the material, nonpublic information that he or she possessed. See *Chiarella*, 445 U.S. at 229. As this Court has noted, "temporary insiders" such as attorneys, accountants, underwriters, and consultants may have such a duty not to trade on nonpublic information, *Dirks*, 463 U.S. at 655 n.14, on the basis of courts'

to those who breach a recognized duty, based in a particular relationship and "in accordance with [a] common-law rule," *Chiarella*, 445 U.S. at 227, not to disclose, nor to use information for their own benefit, without obtaining consent. See *United States* v. *Chestman*, 947 F.2d 551, 567-568 (2d Cir. 1991) (opinion of Meskill, J.), cert. denied, 503 U.S. 1004 (1992). A person who has such a well established duty has no claim to surprise when its breach, by trading on material, nonpublic information belonging to another, supports liability under the federal securities laws.[11]

Third, there can be no contention that respondent lacked adequate notice of the applicability of the misappropriation theory to his trading. "[T]he touchstone is whether the statute, either standing alone or as

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consideration of their entry into a "special confidential relationship" with the business, in which they received information solely for a corporate purpose. *Ibid*.

[11] A lawyer in respondent's position is particularly poorly situated to claim surprise. *Amici* Professor Painter, *et al.*, suggest (Br. 22) that respondent's conduct did not unequivocally violate the standards for lawyers drafted by the American Law Institute (ALI). See *Amici* Br. 22 (citing Draft Restatement (Third) of the Law Governing Lawyers § 111(1)). In fact, the ALI's draft Restatement in August 1987 made clear that lawyers may not "use or reveal confidential client information . . . even if arguably incurring no risk to the interests of the client, if doing so is solely for the lawyer's own enrichment." Restatement § 112 (Preliminary Draft No. 2 (1987)) (quoted in Ann M. Hart, *The* Model Rules *Are Close and the* Restatement *Is Closer*, 10 Geo. J. Legal Ethics 192, 196 n.92 (1996)). And in a later draft, the ALI eliminated the loophole noted by Professor Painter, by stating that a lawyer is prohibited "from using or disclosing confidential client information for the lawyer's personal enrichment, regardless of lack of prejudice to the affected client." Restatement (Third) of the Law Governing Laywers § 112(2), cmt. j (Proposed Final Draft No. 1, Mar. 29, 1996). The confidentiality policy of the Dorsey firm, applicable to respondent, is to the same effect. See J.A. 26-31. *Cf. Carpenter*, 484 U.S. at 322.

construed, made it reasonably clear at the relevant time that the defendant's conduct was criminal." *United States* v. *Lanier*, No. 95-1717 (Mar. 31, 1997), slip op. 7. The misappropriation theory was firmly established at the time of respondent's trades. See *United States* v. *Newman*, 664 F.2d 12 (1981) (upholding misappropriation theory), aff'd after remand, 722 F.2d 729 (2d Cir.), cert. denied, 464 U.S. 863 (1983); H.R. Rep. No. 910, *supra*, at 11 (noting, during passage of ITSFEA, that misappropriation doctrine was already "well established and widely known").

d. Finally, there is no merit to the argument of *amicus* NACDL (Br. 10-14) that the invalidity of the misappropriation theory is demonstrated either by Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b), creating strict liability for short-swing profits by corporate insiders, or the fact that the SEC did not rely on the misappropriation theory when it barred insider trading in *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). Section 16(b) creates liability for nonfraudulent as well as fraudulent trading, and covers only short-swing trading (purchase and sale within a six-month period). "Congress' failure to impose criminal sanctions for nonfraudulent conduct under Section 16(b) does not mean that it intended to immunize insider trading that is fraudulent under Section 10(b) and Rule 10b-5." *United States* v. *Lang*, 766 F. Supp. 389, 402 (D. Md. 1991). And the Commission's articulation of the "classical theory" rather than the misappropriation theory in *Cady, Roberts* reflects the fact that the information in that case was not converted from its rightful owner. See 40 S.E.C. at 917 (noting that corporate insider who gave information to broker "probably assumed, without thinking about it, that the dividend action was already a matter of public information").

3. a. Respondent argues (Br. 33-44) that Rule 14e-3(a) exceeds the SEC's authority under Section 14(e) because the Rule does not require that the trading on nonpublic

information breach a fiduciary duty. In so arguing, however, he makes no effort to respond to our point that the second sentence of Section 14(e) authorizes the SEC to "prescribe means reasonably designed to prevent fraud," which authority "necessarily encompasses the power to proscribe conduct outside the purview of fraud, be it common law or SEC-defined fraud." U.S. Br. 40 (quoting *Chestman*, 947 F.2d at 558 (opinion of Meskill, J.)).

Respondent does suggest (Br. 36) that the Court held in *Schreiber* v. *Burlington Northern, Inc.*, 472 U.S. 1 (1985), that the 1970 Amendments to the Williams Act, which added the second sentence of Section 14(e), did not expand the scope of the "fraudulent, deceptive, or manipulative acts" that are prohibited by Section 14(e). The Court in *Schreiber* noted, however, that even though the term "manipulative" in the first sentence of Section 14(e) includes only deceptive acts, the second sentence "gives the [SEC] latitude to regulate *nondeceptive* activities as a 'reasonably designed' means of preventing manipulative acts." 472 U.S. 11 at n.11 (emphasis added). *Schreiber* therefore recognized that, under the second sentence of Section 14(e), the SEC has authority to prohibit activity that would not constitute manipulation or fraud at common law, and would not be prohibited under the self-operative proscriptions of the first sentence of Section 14(e). Respondent does not answer our showing that prohibiting a class of trading in which a breach of duty is likely but difficult to prove is a "means reasonably designed" to prevent the fraudulent use of confidential information in the tender offer setting. U.S. Br. 43-44.

b. Respondent also contends that there was no "tender offer" within the meaning of Section 14(e) until Grand Met formally authorized and announced its bid, and therefore his trades, which took place before the announcement, did not violate Section 14(e) because they were not "in connection with a tender offer" within the meaning of that

Section. That argument (which was not addressed by the court of appeals) cannot be squared with the purpose of the Williams Act. Under respondent's construction of Section 14(e), bidders and others could engage in fraudulent and manipulative practices without liability under the statute until they announced their offer. If Section 14(e) did not govern at least some events before the formal tender offer, "either party would be free to disseminate misinformation up to the effective date of the tender offer, thus defeating in substantial part the very purpose of the [Williams] Act —informed decisionmaking by shareholders." *Lewis* v. *McGraw*, 619 F.2d 192, 195 (2d Cir.), cert. denied, 449 U.S. 951 (1980). The SEC, recognizing that at least some events before a formal tender offer must be covered to make Section 14(e) effective, has construed the "in connection with" language to encompass situations where a bidder has taken "a substantial step or steps to commence * * * a tender offer." That reading is a reasonable construction of the statute that is entitled to deference. *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

c. Under either of respondent's proffered constructions of Section 14(e)—limiting its reach to breaches of fiduciary duty, or limiting its temporal scope to actions taken after the formal commencement of a tender offer—the SEC would have no authority to prohibit "warehousing," the practice by which bidders leak advance information of a tender offer to allies and encourage them to purchase the target company's stock before the bid is announced. Yet the Court noted in *Chiarella* that at that time the SEC had proposed Rule 14e-3 to prohibit warehousing. The Court recognized that warehousing could be deleterious to the interest of shareholders in a company for which a tender offer has been planned but not announced, since in those situations, "the seller's behavior

presumably would be altered if he had the nonpublic information." *Chiarella*, 445 U.S. at 234.

d. Respondent also argues (Br. 41-44) that Rule 14e-3(a) is invalid because it criminalizes trading before a tender offer occurs without providing notice of when a violation occurs and without requiring scienter. Respondent did not present those arguments to the court of appeals; nor did he object to the district court's instruction to the jury that it was not required to find that respondent knew that the substantial steps had been taken. In any event, the contention is without merit. A violation of Rule 14e-3(a) requires proof that the bidder had taken "substantial steps" towards a tender offer. That standard is no more indefinite than is, for example, the Rule's other requirement that nonpublic information be "material," or the Sherman Act's predication of liability on violations of the "rule of reason." See *United States Gypsum*, 438 U.S. at 445. Even such "general statements of the law are not inherently incapable of giving fair and clear warning." *Lanier*, slip op. 12. And since a criminal violation of Rule 14e-3(a) requires proof of willfulness, *i.e.*, conscious wrongdoing (see pp. 12-13, *supra*), it is unlikely that the Rule will ever be a "'trap for the unwary,' imposing criminal sanctions on 'wholly innocent conduct.'" *Yermian*, 468 U.S. at 74. Moreover, the jury in this case found that respondent knew that the information on which he traded was nonpublic, material, and obtained directly or indirectly from the tender offeror, and that he acted with intent to defraud. See J.A. 204 (jury instructions on Rule 14e-3(a)). Under those circumstances, respondent cannot claim that he was punished for violating the Rule without scienter.

4. Finally, respondent argues (Br. 49) the mail fraud indictment in this case differs from the indictment in *Carpenter* v. *United States*, 484 U.S. 19 (1987), in that the indictment here describes the overall "scheme to defraud"

by alleging fraud "in connection with the purchase and sale of securities." J.A. 8. Respondent claims that if his fraud is not "in connection with" his securities trades within the meaning of Section 10(b), then there can be no fraud "in connection with" his securities trades for purposes of the mail fraud counts. That claim fails because the offense of mail fraud does not contain an "in connection with" element, the jury was not charged that it had to find that respondent's fraud was "in connection with" his purchase of Pillsbury securities on the mail fraud counts, and "[a] part of the indictment unnecessary to and independent of the allegations of the offense proved may normally be treated as 'a useless averment' that 'may be ignored.'" *United States* v. *Miller*, 471 U.S. 130, 136 (1985) (quoting *Ford* v. *United States*, 273 U.S. 593, 602 (1927)).[12]

In any event, respondent's argument does not distinguish the indictment in *Carpenter*. The *Carpenter* indictment first charged that the conspiracy involved "fraud in the purchase and sale of securities," as well as acts "in connection with the purchase and sale of securities" that operated as a fraud (using the language of Rule 10b-5). Resp. Br. App. 3a, ¶¶ 7-8. It then incorporated those conspiracy allegations into the substantive wire fraud counts. *Id.* at 15a, ¶ 40. There is, therefore, no material difference

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[12] In *Miller*, the Court upheld the permissibility of striking superfluous allegations from a mail fraud charge. Consistent with that doctrine, the trial court here did *not* charge the jury that it was required to find, as an element of the mail fraud counts, that the scheme to defraud was "in connection with" the purchase or sale of securities (or that respondent violated Section 10(b)). Rather, the court charged that the jury had to find that respondent had devised a scheme to defraud Grand Met or Dorsey "out of money, property, or property rights by purchasing Pillsbury securities while in possession of material nonpublic information" (J.A. 192). That is a conventional application of the law of mail fraud under *Carpenter*, and a reasonable construction of the indictment.

between the indictment in this case and that in *Carpenter*, and the court of appeals' departure from *Carpenter* cannot be sustained.

* * * * *

For the forgoing reasons, and also for the reasons set forth in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

WALTER DELLINGER
Acting Solicitor General

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No. 96-842

IN THE
Supreme Court of the United States
OCTOBER TERM, 1996

UNITED STATES OF AMERICA,
Petitioner,
v.
JAMES HERMAN O'HAGAN,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE* SUGGESTING REVERSAL IN PART

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QUESTION PRESENTED

Irrespective of whether "misappropriation" is a fraud or deceit actionable under Section 10(b), when a defendant misappropriates inside information in order to trade securities, does the defendant thereby "use or employ" the misappropriation "in connection with the purchase or sale of any security?"

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
TABLE OF AUTHORITIES	iv
PRELIMINARY STATEMENT	1
INTEREST OF THE INSTITUTE AS *AMICUS CURIAE*	1
ARGUMENT	2
I. THIS COURT'S CONSTRUCTION OF THE "USE OR EMPLOY . . . IN CONNECTION WITH" REQUIREMENT OF SECTION 10(b) WILL HAVE FAR-REACHING IMPLICATIONS IN THE POST-*CENTRAL BANK* ERA	2
II. THE "USE OF EMPLOY . . . IN CONNECTION WITH" REQUIREMENT IS A SEPARATE ELEMENT OF LIABILITY FROM FRAUD OR DECEIT; BOTH MUST BE SATISFIED TO STATE A SECTION 10(b) CLAIM	4
CONCLUSION	8

TABLE OF AUTHORITIES

CASES	Page
Anixter v. Home-Stake Prod. Co., 77 F.3d 1215 (10th Cir. 1996)	3
Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)	3
Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 114 S. Ct. 1439 (1994)	2, 5
Frymire-Brinati v. KPMG Peat Marwick, 2 F.3d 183 (7th Cir. 1993)	7
SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991), *cert. denied*, 502 U.S. 1071 (1992)	5
SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985)	5
Superintendent of Ins. v. Bankers Life & Cas., 404 U.S. 6 (1971)	3
STATUTE	
15 U.S.C. § 78j (1994)	*passim*
15 U.S.C. § 78r (1994)	*passim*

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BRIEF OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE* SUGGESTING REVERSAL IN PART

PRELIMINARY STATEMENT

The American Institute of Certified Public Accountants (the "Institute") submits this brief as *amicus curiae*, pursuant to Rule 37.3 of the Rules of this Court, suggesting reversal in part.[1]

INTEREST OF THE INSTITUTE AS *AMICUS CURIAE*

The Institute is the national organization of the certified public accounting profession, with more than 325,000 members. The Institute is interested in the Section 10(b)

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[1] The Institute's brief is submitted on written consents of the parties, which were filed with the Clerk of the Court.

question presented in this case; in particular, the proper interpretation of the "use or employ . . . in connection with" requirement as an element of Section 10(b) liability. The Court's ruling on this issue will extend beyond the misappropriation context and will affect how the lower courts apply the statutory language in other cases, including ones involving more typical allegations of misrepresentations and omissions.

Another case pending before the Court, *Ernst & Young v. McGann*, No. 96-1075, posits the same "use or employ . . . in connection with" question in the context of an alleged misrepresentation by an independent auditor. The Institute believes that consideration of the different factual circumstances of the *O'Hagan* and *McGann* cases will assist the Court in developing a coherent interpretation of the statutory language that can be applied by the lower courts in all Section 10(b) cases.[2]

ARGUMENT

I. THIS COURT'S CONSTRUCTION OF THE "USE OR EMPLOY . . . IN CONNECTION WITH" REQUIREMENT OF SECTION 10(b) WILL HAVE FAR-REACHING IMPLICATIONS IN THE POST-*CENTRAL BANK* ERA.

This Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439 (1994), which overturned aiding and abetting liability under Section 10(b), has focused greater attention on the proper construction of the "use or employ . . . in connection with" requirement of the statute. While aiding and abetting liability existed, there was little need for courts to draw careful distinctions between "primary" and "secondary" liability under the statute. Post-*Central Bank*,

[2] The Institute will file an *amicus* brief supporting Ernst & Young's petition in *McGann* on March 4, 1997. The Institute will serve the *O'Hagan* parties with copies of its *McGann* brief.

the statutory words "*use or employ . . . in connection with the purchase or sale of any security*" have heightened importance in determining conduct that violates the statute and conduct that does not. *See Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1230 (10th Cir. 1996) ("It is obvious from our discussion analyzing accountant behavior under § 10(b) that distinctions in conduct between primary and secondary liability are elusive. Prior to *Central Bank* the distinction was academic. Now it is pivotal.").

The decision below involves application of the "use or employ . . . in connection with" requirement to a defendant's conduct in a misappropriation case. It is equally important for the lower courts to interpret and apply the requirement correctly as to defendants' conduct in other Section 10(b) contexts, including the more typical cases of alleged misrepresentations or omissions.[3] The Institute respectfully urges the Court, in addressing the meaning of these statutory words here, to consider the far-reaching effects that its ruling will have on the full range of Section 10(b) litigation. A proper construction of the requirement should allow for coherent application in varying factual contexts, preserve a meaningful distinction between "primary" and "secondary" liability under the statute, and harmonize the implied Section 10(b) action with the express causes of action in the federal securities laws (most notably, Section 18).

[3] The Court has not previously interpreted the "use or employ . . . in connection with" requirement to determine the sufficiency of a *defendant's* own "connection" to any purchase or sale of securities. In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 727 (1975), the Court looked only at the "connection" required to be a Section 10(b) plaintiff. In *Superintendent of Insurance v. Bankers Life & Casualty*, 404 U.S. 6, 12 (1971), the Court analyzed a complex financial fraud to determine whether it was "in connection with" underlying securities transactions in which both the plaintiffs and defendants were participants.

II. THE "USE OR EMPLOY . . . IN CONNECTION WITH" REQUIREMENT IS A SEPARATE ELEMENT OF LIABILITY FROM FRAUD OR DECEIT; BOTH MUST BE SATISFIED TO STATE A SECTION 10(b) CLAIM.

The Eighth Circuit's decision reflects a troubling inability by the lower courts to give effect to the plain meaning of the "use or employ . . . in connection with" requirement of Section 10(b). Mr. O'Hagan *traded stock* on the basis of misappropriated inside information. *Pet. App.* at 2a-3a. Mr. O'Hagan surely "used" the misappropriated information "in connection with" the purchase of a security, irrespective of whether misappropriation constitutes a "deceptive device" within the meaning of the statute.

The Eighth Circuit held that Mr. O'Hagan was not liable under Section 10(b) for two independent reasons. *First*, the court held that the misappropriation at issue did not constitute an actionable fraud or deceit under Section 10(b). *Id.* at 12a-13a. The Institute takes no position on this part of the decision.

Second, the court held that Mr. O'Hagan had not acted "in connection with" the purchase or sale of a security, even though he *traded stock*. *Id.* at 13a. The court reached this incongruous result by construing the statutory words "in connection with" to define the various classes of persons Congress intended to protect under Section 10(b); *i.e.*, purchasers, sellers, and other "market participants." *Id.* at 13a-14a. The court then concluded that, because Mr. O'Hagan had not breached any fiduciary duty to any of these persons, he had not acted "in connection with" a stock trade for Section 10(b) purposes. *Id.* The full statutory text, however, plainly requires that a *defendant* "use or employ" an alleged fraud "in connection with" a securities transaction.[4] The Eighth Circuit's

[4] Although the words "use or employ" are the operative verbs of the statute, the Eighth Circuit nowhere mentions them in its opinion.

analysis wrongly focused on the effect of the misappropriation on investors, rather than on the defendant's actual *use* of the inside information *in connection with* his stock trades.[5]

The "use or employ . . . in connection with" requirement necessarily operates as a *limitation* on Section 10(b) liability. To give it proper effect, the requirement must be viewed as a separate element from fraud. Whatever a defendant's alleged wrong may be, he or she must "use or employ" it "in connection with" a securities transaction for liability to arise. Both the fraud and the "use or employ . . . in connection with" elements must be shown independently to state a Section 10(b) claim. *Cf. Central Bank*, 114 S. Ct. at 1455 ("[a]ll of the [statutory] requirements for primary liability" must be met.) (emphasis in original).

As a logical matter, truthful statements "used or employed . . . in connection with" a securities transaction may satisfy this element of the statute. Conversely, false representations may constitute fraud within the meaning of Section 10(b), but if the defendant does not "use or employ" them "in connection with" a securities transaction, this separate statutory element is lacking.

The *McGann* case further illustrates this point. In *McGann*, an independent auditor submitted an audit report to a client, which the client later used in a required Form 10-K filing with the SEC. *See McGann Pet. App.* at 3a. The auditor had no involvement or interest in

[5] Courts in other misappropriation cases have found the "use or employ . . . in connection with" requirement to be readily satisfied where a defendant *uses* misappropriated inside information to trade stocks. *See, e.g., SEC v. Cherif*, 933 F.2d 403, 410 (7th Cir. 1991) (requirement satisfied by defendant's use of inside information to purchase or sell securities), *cert. denied*, 502 U.S. 1071 (1992); *SEC v. Materia*, 745 F.2d 197, 203 (2d Cir. 1984) (use of inside information to purchase stock provides "self-evident nexus"), *cert. denied*, 471 U.S. 1053 (1985).

the disputed stock transactions. The Ninth Circuit nonetheless held that the auditor had "use[d] or employ[ed]" the report "in connection with the purchase or sale" of a security. *Id.* at 16a-17a. The Ninth Circuit reached this conclusion by making the same mistake as the Eighth Circuit: the court ignored the statutory text, and looked instead to perceived investor protection policies underlying Section 10(b). The court concluded that the "use or employ . . . in connection with" requirement is satisfied whenever any person makes any statement "in a manner reasonably calculated to influence the investing public." *Id.* at 15a. The court's focus was improperly on the *making* of a false statement and its potential *effect* on investors.

Section 10(b), however, plainly requires more than the making of a false statement that affects the price of a stock. The statutory words say that the defendant must further "*use*" the statement "*in connection with*" a purchase or sale of securities. This requirement distinguishes the implied Section 10(b) action from the express right of action under Section 18. Section 18 imposes civil liability on accountants and others who "make or cause to be made" a false statement in a publicly filed document that "affect[s]" the price of a stock and that is relied upon by investors.[6] Section 18 demonstrates that Congress knew which words to choose to create an express remedy

[6] Section 18 states, in pertinent part, that:

> Any person who shall make or cause to be made any statement in any . . . document filed pursuant to this chapter or any rule or regulation thereunder . . . which statement was . . . false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement . . . unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.

15 U.S.C. § 78r (1994).

for the making of false statements that affect stock prices (*viz*, precisely the conduct alleged against the *McGann* auditor). The very different words chosen by Congress in Section 10(b) must be read to mean something more. The policy-based *McGann* holding fails to give proper effect to the plain meaning of the "use or employ . . . in connection with" words of Section 10(b) and, in so doing, improperly nullifies the actual reliance requirement of Section 18 by permitting plaintiffs—in *every* case involving an allegedly false SEC filing—to plead the same alleged false statements as "fraud-on-the-market" claims under Section 10(b).[7]

The *McGann* holding thus poses the same problem as the one in *O'Hagan*, but from the opposite end of Section 10(b): the independent auditor's alleged misrepresentation may constitute a "deceptive device" within the meaning of the statute, but the auditor did not "use or employ" the misrepresentation "in connection with" any of the disputed transactions. To the contrary, in cases like *McGann*, the independent auditor is retained by the client, audits financial statements prepared by the client, and submits the audit report to the client. The client may use the report for a host of different business purposes, including compliance with regulatory disclosure requirements. *See Frymire-Brinati v. KPMG Peat Marwick*, 2 F.3d 183, 190 (7th Cir. 1993) (discussing different client uses of audit reports). Whatever uses the client may make of its audited financial statements, the auditor's role is necessarily secondary.[8] It strains the text of Section 10(b) too far to say—especially after *Central Bank*—that, by merely issuing the audit report to the client, the independent auditor has "used or employed" the report "in connection with the purchase or sale of any security."

[7] *See AICPA McGann Amicus Brief* at I.B.

[8] *See McGann Pet.* at 21-23; *AICPA McGann Amicus Brief* at II.A.

This separate requirement for primary Section 10(b) liability simply is not satisfied.

In sum, giving proper effect to the plain text of the statute allows for coherent application of the "use or employ . . . in connection with" requirement as a separate element of Section 10(b) liability in varying fact scenarios. It also preserves a meaningful distinction between "primary" and "secondary" liability under the statute, and harmonizes the implied Section 10(b) and express Section 18 actions.

CONCLUSION

For the foregoing reasons, the Institute respectfully urges the Court to hold (1) that Section 10(b) requires, for primary liability under the statute, that a defendant "use or employ" a fraud "in connection with" a particular purchase or sale of securities, and (2) that this element must be satisfied *independently* of whether the fraud itself is a "deceptive device" within the meaning of the statute.

Respectfully submitted,

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In The

Supreme Court of the United States

October Term, 1996

UNITED STATES OF AMERICA,

Petitioner,

vs.

JAMES HERMAN O'HAGAN,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

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TABLE OF CONTENTS

	Page
Consent to Parties	1
Interest of *Amici*	1
Summary of Argument	2
Argument	4
I. Respondent Violated Section 10(b) Of The Securities Exchange Act of 1934 And Rule 10b-5 When He Used Material Nonpublic Information To Trade Securities For Personal Gain In The Public Securities Markets In Breach Of His Fiduciary Duties To The Sources Of That Information, His Firm And A Client Of His Firm With A Known Interest In Such Securities.	4
A. The misappropriation theory appropriately balances the need to protect confidential corporate information with the need for analysts and investors to conduct and have access to securities research and information.	4
B. The misappropriation theory as articulated in the Second, Seventh and Ninth Circuits but rejected below is a valid interpretation of Rule 10b-5, consistent with Section 10(b).	9

Contents

Page

C. This Court should recognize a duty under Section 10(b) not to trade on the basis of misappropriated material nonpublic information. 10

II. Rule 14e-3 Is A Valid And Enforceable Rule. . 14

III. The Validity Of Both The Misappropriation Theory Under Rule 10b-5 And Rule 14e-3 Has Been Codified By Statute. 16

A. In legislation enacted in 1984 and 1988, Congress confirmed and codified that it is a violation of Section 10(b) and Rule 10b-5 for a person who has learned material nonpublic information in the course of a special relationship of trust and confidence to trade securities on the basis of that information in violation of fiduciary duties. 16

B. Section 2 of the Insider Trading and Securities Fraud Enforcement Act of 1988 confirmed and codified that Rule 14e-3 is a valid and enforceable rule and that it is a violation of Section 10(b) and Rule 10b-5 to trade securities in the public securities markets based on material nonpublic information in breach of fiduciary duties. 20

Contents

Page

C. The 1988 Act's enacted declaration of long-standing congressional intent is entitled to substantial weight, even with respect to trades occurring before its enactment. 24

Conclusion 27

TABLE OF CITATIONS

Cases Cited:

Alexander v. Mayor & Commonalty of Alexandria, 9 U.S. (5 Cranch) 1 (1809) 26

Bateman Eichler Hill Richards, Inc. v. Berner, 472 U.S. 299 (1985) 13

Cady, Roberts, 40 S.E.C. 907 (1961) 12

Carpenter v. United States, 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987) 6, 7, 10

Central Bank v. First Interstate Bank, 511 U.S. 164 (1994) 25, 27

Chiarella v. United States, 445 U.S. 222 (1980) 11, 12, 13, 15, 22, 27

Dirks v. SEC, 463 U.S. 646 (1983) 5, 7, 10, 12, 13, 17, 22, 27

Contents

	Page
Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1975) ...	27
Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991)	22
In re Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933 (1968)	5, 17
Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984)	18, 19
NLRB v. Bell Aerospace Co., 416 U.S. 267 (1974) ...	24, 26
Phillips v. Homfray, L.R. 6 Ch. App. 770 (1871)	12
Postmaster v. Early, 25 U.S. 136 (1827)	26
Red Lion Broadcasting Co. v. FCC, 395 U.S. 367 (1969)	26
Rothberg v. Rosenbloom, 771 F.2d 818 (3d Cir. 1985)	9
Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977)	27
Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985)	15
SEC v. Clark, 915 F.2d 439 (9th Cir. 1990)	9, 19

Contents

	Page
SEC v. Ferrero, [1993-1994 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 98 (S.D. Ind. Dec. 2, 1993)	14
SEC v. Lenfest, 1996 U.S. Dist. LEXIS 18961 (E.D. Pa. Dec. 23, 1996)	9
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SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985)	9, 16
SEC v. Peters, 978 F.2d 1162 (10th Cir. 1992)	14
SEC v. Singer, 786 F. Supp. 1158 (S.D.N.Y. 1992) ..	9
SEC v. Willis, 787 F. Supp. 58 (S.D.N.Y. 1992)	9
United States v. Bryan, 58 F.3d 933 (4th Cir. 1995) ..	7, 8
United States v. Cherif, 943 F.2d 692 (7th Cir. 1991), *cert. denied*, 503 U.S. 961 (1992)	9
United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992)	7, 9, 14, 15, 19
United States v. Libera, 989 F.2d 596 (2d Cir.), *cert. denied*, 510 U.S. 976 (1993)	9
United States v. Newman, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983)	6, 9

Contents

Page

United States v. Winstar Corp., 116 S. Ct. 2432 (1996) 24, 26

Statutes Cited:

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Securities Exchange Act of 1934, 15 U.S.C. §§ 78a, *et seq.*:

§ 20(d), 15 U.S.C. § 78t(d) 17, 18

§ 20A, 15 U.S.C. § 78t-1 .....6, 18, 19, 22

§ 23(a), 15 U.S.C. § 78w(a) 21

§ 28, 15 U.S.C. § 78bb 1

15 U.S.C. § 78u-1 21

Rules Cited:

Rule 10b-5, 17 C.F.R. § 240.10b-5 ..... *passim*

Rule 14e-3, 17 C.F.R. § 240.14e-3 ..... *passim*

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Contents

Page

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European Economic Community Council Directive on Insider Dealing, *reprinted in* O.J. Econ. Comm. L 334/30 (Nov. 18, 1989) 6

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Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 Stan. L. Rev. 385 (1990) 5

Contents

	Page
William C.S. Wang & Marc I. Steinberg, Insider Trading (1996)	5, 6

APPENDIX

Appendix A - Law Professors Joining the Brief	1a

CONSENT OF PARTIES

Petitioner and respondent have consented to the filing of this brief, *amici curiae*.[1]

INTEREST OF *AMICI*

This brief, *amici curiae*, is submitted on behalf of the North American Securities Administrators Association, Inc. ("NASAA") and a group of law professors at universities in the United States.[2]

NASAA is the forum in which the securities regulators of the fifty states, the District of Columbia, Puerto Rico, the Canadian provinces and territories and the Republic of Mexico ("Members") work in conjunction with each other and with federal and international securities regulators to protect investors and to promote fair, open and honest capital markets. State, provincial and territorial securities commissioners are charged with regulating the securities markets and combating securities frauds in their respective jurisdictions. NASAA is the collective voice for its Members in advancing those interests. The dual system of federal and state securities regulation is recognized by Section 18 of the Securities Act of 1933, 15 U.S.C. § 77r (1994), and by Section 28 of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb (1994), which preserves enforcement of state antifraud provisions. Congress recently preserved that role in the National Securities Markets Improvement Act of

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1. Their consents have been filed with the clerk of this Court. This brief was authored by the amici and counsel listed on the front cover hereof, and was not authored in whole or in part by counsel for a party. No one other than the amici and their counsel made any monetary contribution to the preparation or submission of this brief.

2. The law professors are listed in an appendix to this brief.

1996. Pub. L. No. 104-290, 110 Stat. 3416 (1996) (to be codified in various Sections of 15 U.S.C.).

NASAA has a dual interest in the present case. First, the antifraud provisions in the Uniform Securities Act of 1956 are modeled after the federal provisions central to this case. NASAA has a great interest in the collateral effect of judicial interpretations of federal provisions on state statutes. Uniform interpretations provide important guidance to market participants concerning the parameters of acceptable behavior in the marketplace. Moreover, state courts, having correspondingly fewer cases construing state acts, often look to applicable federal precedent when deciding cases, particularly from this Court. Second, as an association of state securities regulators, NASAA has an interest in the effected enforcement of federal and state securities laws to police our markets and maintain investor confidence. NASAA wishes to express its own views herein as the Court revisits the misappropriation theory under Section 10(b) of the Exchange Act and Rule 10b-5.

As teachers and scholars of corporate law and securities regulation, the law professor amici are interested in the proper interpretation and application of the federal securities laws. The law professor amici have received no compensation or promise of compensation for submitting this brief. They join this brief solely because they believe that the Eighth Circuit improperly construed the federal securities laws and that affirmance of its decision would impede the proper functioning of those laws.

SUMMARY OF ARGUMENT

1. Respondent violated Section 10(b) of the Exchange Act and Rule 10b-5 when he used material nonpublic information he obtained through a relationship of trust and confidence to trade securities in the public securities markets in breach of his fiduciary duties to his firm and a client of his firm with an interest

in such securities. The SEC is authorized to prohibit such trading by Section 10(b), and has done so with Rule 10b-5. Prohibition of such trading serves important federal interests and protects fiduciary relationships while at the same time assuring adequate incentives for securities research and information verification.

This Court should adopt the theory previously adopted in the Second, Seventh and Ninth Circuits, but rejected below, that a person who has been entrusted with material nonpublic information and assumed a duty not to use it for personal profit violates Section 10(b) and Rule 10b-5 if he subsequently uses that information to trade securities in the public market in breach of that duty. Respondent's trading consummated a deception, and that deception was in connection with the purchase or sale of securities, particularly because his firm's client was interested in purchasing securities.

Independently of the theory adopted by most courts that a person who trades securities on the basis of material nonpublic information in breach of fiduciary duties violates Section 10(b) and Rule 10b-5, this Court should hold that a person who trades on the basis of misappropriated material nonpublic information violates Section 10(b) and Rule 10b-5. This theory of liability responds to the same kind of deception of marketplace traders through silence that is present when corporate insiders illegally trade on inside information, and because the victims of this fraudulent concealment are themselves trading contemporaneously with the wrongdoer, the deception is clearly "in connection with" the purchase or sale of securities.

2. Rule 14e-3 is a valid and enforceable rule. Section 14(e) of the Exchange Act authorized the SEC to promulgate Rule 14e-3. Rule 14e-3 appropriately and lawfully responds to the special problems posed by the possibility that those privy to information about tender offers may abuse that information by trading securities.

3. The validity of the misappropriation theory under Section 10(b) and Rule 10b-5 and of Rule 14e-3 has been confirmed by statute. Amendments to the Exchange Act enacted in 1984 and 1988 established that it is a violation of Section 10(b) and Rule 10b-5 for a person who has learned material nonpublic information in the course of a relationship of trust and confidence to trade securities on the basis of such information in violation of duties assumed in that relationship. The 1988 legislation also spoke directly to the SEC's rulemaking authority and established that the misappropriation theory and Rule 14e-3 are within the SEC's rulemaking power.

ARGUMENT

I.

RESPONDENT VIOLATED SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 10b-5 WHEN HE USED MATERIAL NONPUBLIC INFORMATION TO TRADE SECURITIES FOR PERSONAL GAIN IN THE PUBLIC SECURITIES MARKETS IN BREACH OF HIS FIDUCIARY DUTIES TO THE SOURCES OF THAT INFORMATION, HIS FIRM AND A CLIENT OF HIS FIRM WITH A KNOWN INTEREST IN SUCH SECURITIES.

A. The misappropriation theory appropriately balances the need to protect confidential corporate information with the need for analysts and investors to conduct and have access to securities research and information.

When respondent used material nonpublic information obtained in the course of a special relationship of trust and confidence to trade securities for his personal benefit in breach of his fiduciary duties, he injured both the corporation whose secrets and plans had been entrusted to him and his law firm,

whose confidence he betrayed, and he undermined the efficiency and integrity of the securities markets. The federal securities laws protect against such injuries by making it unlawful to trade securities on the basis of informational advantages that public investors cannot lawfully overcome.[3] At the same time, the federal securities laws recognize the importance of the legitimate discovery and use of information, and accordingly do not require that everyone who possesses material nonpublic information disclose it. Instead, as this Court recognized in *Dirks v. SEC*, "in an inside-trading case this fraud derives from the 'inherent unfairness involved where one takes advantage' of 'information intended to be available only for a corporate purpose and not for the personal benefit of anyone.' " 463 U.S. 646, 654 (1983) (*quoting In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 936 (1968)).

The misappropriation theory appropriately balances the protection of confidences with the production and dissemination of information. It forbids conversion, by trading, of information belonging to another in violation of a pre-existing legal, contractual or fiduciary duty. Such misuse of information is the very opposite of legitimate information production, and indeed the risk of misappropriation reduces the incentive to produce information in the first place. By keying the prohibition of trading to the existence and breach of a duty of confidentiality, the misappropriation theory fully protects legitimate research and analysis, while also protecting the creators of information

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3. *See* Donald C. Langevoort, Insider Trading: Regulation, Enforcement & Prevention (1996); 7-8 Louis Loss & Joel Seligman, Securities Regulation 3404-3937 (3d ed. 1991 & Supp.); William K.S. Wang & Marc I. Steinberg, Insider Trading (1996); Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 Harv. L. Rev. 322 (1979); *see also* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 Stan. L. Rev. 385 (1990) (suggesting that Section 10(b) gives the SEC extremely broad rulemaking power).

and the efficiency and integrity of the securities markets. It is noteworthy that policy makers trying to balance the interests of those information owners who legitimately expect their own officers, directors and professional service providers to refrain from trading on such information with the public interest in vigorous securities research and analysis, consistently conclude that the misappropriation theory strikes the correct balance.[4] The misappropriation theory could hardly work to chill legitimate information production in any event, inasmuch as the federal mail and wire fraud statutes independently prohibit most misappropriation. *See Carpenter v. United States*, 484 U.S. 19 (1987). The availability of these statutes should not preclude application of the securities laws, however, since the securities laws may be enforced by the SEC in civil and administrative actions and by contemporaneous public traders in civil actions under Section 20A of the Exchange Act, 15 U.S.C. § 78t-1 (1994).

Respondent's trading endangered his law firm's client, Grand Metropolitan PLC, and injured the public interest in efficient securities markets. It is well established that trading in advance of a tender offer on the basis of confidential material information obtained from the tender offeror may seriously injure the offeror because it can alert the target, legally embarrass the offeror, and increase the acquisition price to the offeror to the extent such trading can be decoded by participants in the market as a sign of an impending tender offer. *See United States v. Newman*, 664 F.2d 12, 17-18 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983); W. Wang & M. Steinberg, *supra*, at 496. Both respondent's law firm and its client had an acute interest in keeping their plans secret and assuring that respondent did not

4. *See* D. Langevoort, *supra*, ch. 13 (discussing various legislative proposals); *see also* European Economic Community Council Directive on Insider Dealing, *reprinted in* O.J. Econ. Comm. L334/30 (Nov. 18, 1989).

alert the market to the impending tender offer by his trading.[5] Thus, it was by his act of trading that respondent endangered those to whom he owed a duty of confidence, and it was his trading that constituted his breach of duty. Absent trading by respondent or a tippee, respondent's conduct could not have injured Grand Metropolitan; therefore, respondent's trading was not separate from his breach of duty, but was the direct cause and consummation of that breach.

The fact that respondent's trading endangered Grand Metropolitan's own trading, distinguishes this case from others in which the victim of the breach of duty was not itself a market participant. For example, in *Carpenter v. United States*, 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987), the *Wall Street Journal* did not have an interest in the securities traded by its faithless agent and his tippees, *see* 791 F.2d at 1028-29, although it did have an interest in maintaining its reputation for honest reporting. Grand Metropolitan's interest in the traded securities also distinguishes *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995), whose analysis the Eighth Circuit purported to adopt "in its entirety as our own." *See* 92 F.3d at 620. Although the Fourth Circuit refused to apply the misappropriation theory in *Bryan* where the victim of the misappropriation (a state agency) was not a market participant, it suggested that a very different situation would have been presented had the owner of the information been trading. According to the Fourth Circuit, Section 10(b) "reaches only deception of persons *with some*

5. *See Dirks v. SEC*, 463 U.S. at 655 n.14 ("For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty."); *see also United States v. Chestman*, 947 F.2d 551, 576-78 (2d Cir. 1991) (*en banc*) (Winter, J., concurring in part and dissenting in part) (emphasizing the harm to confidentiality and business property caused by those who breach duties of confidence by trading on material nonpublic information), *cert. denied*, 503 U.S. 1004 (1992).

connection to, or some interest or stake in, an actual or proposed purchase or sale of securities." 58 F.3d at 950 (emphasis added). Respondent's trading did directly injure and deceive his firm and its client, which had a very clear "connection to" and "interest or stake in" a proposed purchase of securities.

By trading for personal gain on the basis of confidential information that he had no right to use, respondent also injured the efficiency and integrity of our securities markets — a concern that is now more vital than ever as securities trading becomes globalized. Trading in organized securities markets is usually effected through specialized intermediaries (*e.g.*, market makers in dealer markets or specialists on the exchanges), who determine a bid-ask spread at which they trade with public customers. The width of the spread between the prices at which intermediaries will buy or sell (the bid-ask spread) is essentially a measure of the efficiency of the market for a security. While dealers and specialists are the initial victims of those who trade on misappropriated material nonpublic information, they pass this injury along to public customers through a widened bid-ask spread. To the extent it is foreseeable that people will trade with misappropriated material nonpublic information, intermediaries must protect themselves in advance by widening the bid-ask spread. Thus trading by those who misappropriate material nonpublic information for personal profit necessarily injures all public customers by decreasing the price at which they can sell to intermediaries (the bid) and increasing the price at which they can buy from intermediaries (the ask). Indeed, customers trading other securities will also be injured, because dealers cannot anticipate which securities will be traded by those in possession of material nonpublic information and will consequently widen the bid-ask spread for all securities that may be the subject of such information.[6] Trading on misappropriated

6. *See* Lawrence R. Glosten, *Insider Trading, Liquidity, and the Role of the Monopolist Specialist*, 62 J. Bus. 211 (1989).

information, like insider trading, decreases market efficiency and thus adversely affects all who trade in the public securities markets.

B. The misappropriation theory as articulated in the Second, Seventh and Ninth Circuits but rejected below is a valid interpretation of Rule 10b-5, consistent with Section 10(b).

Respondent violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 when he used material nonpublic information to trade securities in the public securities markets in breach of his fiduciary duties to his firm and a client of his firm with an interest in such securities. Section 10(b) makes it unlawful for *any person* to use or employ, in connection the purchase or sale of *any security*, any manipulative or deceptive device or contrivance in contravention of such rules as the SEC may prescribe as necessary or appropriate in the public interest or for the protection of investors. Rule 10b-5 forbids any person to engage in any act or practice which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of securities. Three courts of appeal and several district courts have held that Section 10(b) and Rule 10b-5 reach those who breach a duty of trust and confidence by misappropriating material nonpublic information through the act of trading.[7] These courts grounded their decisions

7. *See United States v. Cherif*, 943 F.2d 692 (7th Cir. 1991), *cert. denied*, 503 U.S. 961 (1992); *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990); *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983); *see also United States v. Libera*, 989 F.2d 596 (2d Cir.), *cert. denied*, 510 U.S. 976 (1993); *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985); *SEC v. Lenfest*, 1996 U.S. Dist. LEXIS 18961 (E.D. Pa. Dec. 23, 1996); *SEC v. Willis*, 787 F. Supp. 58 (S.D.N.Y. 1992); *SEC v. Singer*, 786 F. Supp. 1158 (S.D.N.Y. 1992); *cf. United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (*en banc*) (endorsing doctrine but finding no duty in family relationship), *cert. denied*, 503 U.S. 1004 (1992); *Rothberg v. Rosenbloom*, 771 F.2d 818 (3d Cir. 1985).

in the language and structure of the Exchange Act, and amici agree with their analysis. This Court should also hold that such trading is within the proscription of the Exchange Act.

Respondent employed a deceptive device and contrivance in contravention of Rule 10b-5, and thereby violated Section 10(b), when he used confidential material nonpublic information obtained from his firm's client to buy securities in the public market. The jury apparently found that respondent falsely represented himself as a faithful agent, pretended to perform his duty to safeguard information he received from the firm, made "secret profits" from the confidential information entrusted to him or failed to disclose his breach of his duty of confidentiality. *See Carpenter v. United States*, 484 U.S. 19, 27-28 (1987); *Dirks v. SEC*, 463 U.S. 646, 654, 655 n.14 (1983). This pattern of deception is within the scope of Section 10(b) and Rule 10b-5 and was "in connection with" the purchase or sale of a security. Respondent breached his fiduciary duties as a partner of his firm and to its client when and only when he purchased securities. His firm's client expected strict confidentially regarding its plans precisely because it was about to make substantial purchases of its own. Indeed, the material nonpublic information that respondent misused was that his firm's client was about to purchase securities.

C. This Court should recognize a duty under Section 10(b) not to trade on the basis of misappropriated material nonpublic information.

For the reasons stated above, the misappropriation theory as articulated by a majority of the courts of appeals that have considered the issue — the "fraud on the source" theory — is well grounded in the Exchange Act. But even if criticism of that theory were persuasive, this Court can and should hold that a person who trades securities on the basis of misappropriated

material nonpublic information violates Section 10(b) and Rule 10b-5, and affirm respondent's conviction.[8]

When the *Chiarella* case came before this Court, the United States made two separate arguments that Chiarella's conviction should be upheld because he had misappropriated information from his employer (a financial printer) and his employer's customers (bidders in various takeover battles). Because the Court found that neither theory was properly presented to the jury during the criminal trial, it expressly refused to rule on them and thus reserved both for future consideration. 445 U.S. at 236-37. One theory was that this misappropriation operated as a fraud on the printer and its customers. This theory, which was referred to in Justice Stevens' concurring opinion, *id.* at 238, later evolved into the "fraud on the source" standard now accepted in the Second, Seventh and Ninth Circuits.

The government's other misappropriation theory was different. It argued that the misappropriation of information in violation of a duty of trust and confidence should give rise to a duty to disclose this information to other marketplace traders. This theory, again specifically reserved by this Court because of the failure of the jury instructions to refer to it, received a strong endorsement from Chief Justice Burger in his dissenting opinion in *Chiarella*. *Id.* at 239-43. The Chief Justice took note of common law history that has long used the law of fraud to prevent the exploitation of stolen information.[9]

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8. Because the jury found that respondent misappropriated information and because the difference between the two misappropriation theories is a matter of characterizing the legal effect of a misappropriation, there is no unfairness to respondent in sustaining his conviction on the basis of a disclosure obligation even if the "fraud on the source" theory is rejected.

9. Chief Justice Burger cited the classic article by the late Dean Page

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Chief Justice Burger's disclosure-based misappropriation theory of liability is a sound and sensible application of Section 10(b) and Rule 10b-5, and it satisfies the statutory requirements of deception and a connection to the purchase or sale of securities. Violation of a duty to disclose that is imposed on those who steal information involves exactly the same kind of deception of other marketplace traders through silence as the now well-established duty to disclose imposed on corporate insiders and tippees after *Chiarella* and *Dirks*. *See Dirks*, 463 U.S. at 653 n.10 ("[T]he *Cady, Roberts* Commission recognized, and we agree, that '[a] significant purpose of the Exchange Act was to eliminate the idea that use of inside information for personal advantage was a normal emolument of corporate office.' ") (*quoting Cady, Roberts*, 40 S.E.C. 907, 912 n.15 (1961)); *id.* at 654. And because the victims of this fraudulent concealment are the buyers or sellers of securities trading contemporaneously with the misappropriator, the "in connection with" requirement of Section 10(b) is amply satisfied. Thus, reframing the misappropriation theory in terms of a disclosure duty completely deflates the two principal objections to it made by the court below.

As noted above, *Chiarella* expressly leaves open the possibility of this alternative duty of disclosure to the marketplace. Although dicta in *Dirks* might arguably be read to foreclose this avenue, the Court in that case explained that Rule

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Keeton, *Fraud-Concealment and Non-Disclosure*, 15 Tex. L. Rev. 1, 25-26 (1936), in which the author summarizes his view of the law that "Any time information is acquired by means of an illegal act it would seem that there should be a duty to disclose that information." *See, e.g., Phillips v. Homfray*, L.R. 6 Ch. App. 770, 779-80 (1871). The common law has evolved to a point where a duty to disclose is routinely imposed in cases involving the unfair exploitation of superior knowledge or expertise. *See* Deborah A. DeMott, *Do You Have a Right to Remain Silent? Duties of Disclosure in Business Transactions*, 19 Del. J. Corp. L. 65 (1994).

10b-5 bars so-called temporary insiders from tipping or trading on the basis of material nonpublic information because "they have entered into a special confidential relationship with the source of that information and are given access to information solely for purposes of that relationship." 463 U.S. at 655 n.14. The Court also held that to determine whether an insider's disclosure of material nonpublic information "itself 'deceive[s], manipulate[s] or defraud[s]' shareholders, the initial inquiry" focuses on "whether the insider receives a direct or indirect personal benefit from the disclosure," *id.* at 663, not on communications between the insider and the investors with whom the tippee(s) trade. Moreover, in absolving Dirks from liability, the Court took pains to point out that Dirks did not "misappropriate or illegally obtain the information about Equity Funding." *Id.* at 665. The Court's holding, therefore, does not foreclose a viable alternative duty of disclosure when there has been a misappropriation. In *Bateman Eichler Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985), this Court interpreted *Dirks* to leave room for a duty based on misappropriation, saying that "[w]e have noted that a tippee may be liable if he otherwise 'misappropriate[s] or illegally obtain[s] the information.' " *Id.* at 313 n.22 (*quoting Dirks*, 463 U.S. at 665).

For the reasons stated in Part I(A) of this brief, a duty to disclose based on misappropriation is a sound mechanism for promoting the efficiency of the securities markets and avoiding the tangible harm to market institutions that flows from the exploitation of stolen information. Unlike the "parity of information" theories rejected in *Chiarella* and *Dirks*, such a disclosure duty would not threaten legitimate research or analysis, or innocent investor behavior. Just as under the fiduciary obligation theory articulated in *Chiarella* and *Dirks*, disclosure is compelled only when the information is the property of another and the trading violates a pre-existing legal duty of loyalty, so that the trader cannot claim to deserve the trading profits from information that the victim could not lawfully obtain.

Recognizing a misappropriation-based duty to disclose squares well, then, with the underlying purpose and philosophy of Section 10(b) and Rule 10b-5. It is also structurally consistent with the statutory provisions governing insider trading enforcement that Congress enacted in 1984 and 1988. As discussed in Part III of this brief, Congress' decision in Section 20A of the Exchange Act to allow all contemporaneous marketplace traders to recover damages from a violator — without regard to whether they stood in any pre-existing fiduciary relationship — constituted legislative recognition of a duty running from the trader to marketplace victims.[10] If they were owed no disclosure duty, Congress would have had no reason to grant them the right to recover that it did.

II.

RULE 14e-3 IS A VALID AND ENFORCEABLE RULE.

The court of appeals erred when it held that Rule 14e-3 exceeded the SEC's rule-making authority. Three other courts of appeals have held that Rule 14e-3 is within the rule-making authority conferred on the SEC by the Exchange Act.[11] These decisions were grounded in the language and structure of the Exchange Act, and amici agree with their analysis.

Once the court below rejected the misappropriation theory under Section 10(b) and Rule 10b-5, it found that Rule 14e-3 had to be invalid as well. According to the court, "although

10. *See also* D. Langevoort, *supra*, at 6-33, 9-16; Lawrence E. Mitchell, *The Jurisprudence of the Misappropriation Theory: From Fairness to Efficiency and Back*, 52 Alb. L. Rev. 775 (1988).

11. *See SEC v. Maio*, 51 F.3d 623 (7th Cir. 1995); *SEC v. Peters*, 978 F.2d 1162 (10th Cir. 1992); *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (*en banc*), *cert. denied*, 503 U.S. 1004 (1992); *see also SEC v. Ferrero*, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,120 (S.D. Ind. Dec. 2, 1993).

perhaps § 14(e) is the product of clearer legislative draftsmanship [than is Section 10(b)], the authority granted to the SEC under both provisions is fundamentally the same." 92 F.3d at 626. According to the court, if the Commission could not forbid trading on the basis of misappropriated information under Section 10(b), it followed that "the SEC exceeded its rulemaking authority by enacting Rule 14e-3 without including the requirement of a breach of a fiduciary duty." 92 F.3d at 624.

This reading of Section 14(e) renders its grant of rule-making authority unnecessary surplusage. Section 14(e) makes it "unlawful for any person . . . to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer." Thus Section 14(e), unlike Section 10(b), contains a self-operative proscription of fraud, so that fraudulent conduct in connection with a tender offer violates Section 14(e) itself, and it does so entirely apart from any SEC rule. However, Section 14(e) also provides that the SEC shall "by rules and regulations define, and prescribe means reasonably designed to prevent such acts and practices as are fraudulent, deceptive, or manipulative." Inasmuch as fraudulent, deceptive and manipulative acts in connection with tender offers violate the statutory prohibition of Section 14(e) — and did so before the section was amended to give the Commission rule-making authority — the Commission's rule-making power under Section 14(e) extends to the regulation of conduct that is not necessarily fraudulent, deceptive, or manipulative, but that should be prescribed to prevent fraud, deception or manipulation.[12]

Tender offers present particularly acute problems of insider

12. *See United States v. Chestman*, 947 F.2d 551, 558 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992). This Court has recognized the breadth of the Commission's Section 14(e) rule-making power. *See Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 12 n.11 (1985); *see also Chiarella v. United States*, 445 U.S. 222, 234 (1980).

trading, given the sensitivity of the securities markets to information about tender offers and the possibility that those privy to information about such offers may abuse that information. Rule 14e-3 appropriately responds by forbidding securities trading by those in possession of material nonpublic information relating to a tender offer, if they know or have reason to know that the information comes from the tender offeror or target.[13] It is reasonably designed to prevent "fraudulent, deceptive, or manipulative" conduct.

III.

THE VALIDITY OF BOTH THE MISAPPROPRIATION THEORY UNDER RULE 10b-5 AND RULE 14e-3 HAS BEEN CODIFIED BY STATUTE.

The misappropriation theory under Rule 10b-5 and Rule 14e-3 are both well grounded in the language of Sections 10(b) and 14(e) of the Exchange Act. Even if their validity had initially been in question, however, Congress has legislatively codified the validity of the misappropriation theory and of Rule 14e-3 in enacted statutes and incorporated the misappropriation theory and Rule 14e-3 into the statutory regulatory scheme.

A. In legislation enacted in 1984 and 1988, Congress confirmed and codified that it is a violation of Section 10(b) and Rule 10b-5 for a person who has learned material nonpublic information in the course of a special relationship of trust and confidence to trade securities on the basis of that information in violation of fiduciary duties.

The court below rejected the misappropriation theory on the ground that insider trading cannot violate Section 10(b)

13. *See SEC v. Materia*, 745 F.2d 197, 199 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985).

unless the trader violates "a duty to parties to the securities transaction, or, at the most, to other market participants," 92 F.3d at 618, and it held Rule 14e-3 invalid on the theory that the any rule adopted under Section 14(e) must be limited to traders who breach a fiduciary duty. *Id.* at 624. However, Congress itself has made trading while in possession of material information illegal even when traders owe no fiduciary duty to those with whom they trade, and it has rejected the premise that liability attaches only when those in possession of material nonpublic information trade in breach of fiduciary duties.

In the Insider Trading Sanctions Act of 1984, Congress made it illegal for corporate insiders to trade options on corporate securities while in possession of material nonpublic information, although such insiders owe no duty to public options traders.[14] Section 20(d) of the Exchange Act, 15 U.S.C. § 78t(d) (1994), enacted in 1984, makes it unlawful to trade options while in possession of material nonpublic information whenever it would be unlawful to trade the underlying security. Publicly traded options are typically issued by securities dealers (and not by the corporations that issue the securities underlying such options), and corporations and their insiders do not owe fiduciary duties to those who own or trade options on corporate securities when those options are issued by others. Thus the statutory prohibition of option trading by those in possession of material nonpublic information is not based on the existence of the trader's duty to other market participants. Instead, liability is premised on the idea that, as this Court observed in *Dirks*, "fraud derives from the 'the inherent unfairness involved where one takes advantage' of 'information intended to be available only for a corporate purpose and not for the personal benefit of anyone.' " 463 U.S. at 654 (*quoting In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 936 (1968)). The 1984 Act

14. *See* Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified in scattered sections of 15 U.S.C.).

generalized the misappropriation theory, extending it beyond trading in corporate securities to trading in derivative securities based on the value of such securities. This extension makes sense only on the assumption the Congress already believed that any person trading on misappropriated material nonpublic information was violating Section 10(b) and Rule 10b-5, and Section 20(d) of the Exchange Act codified this belief as substantive law.

In the Insider Trading and Securities Fraud Enforcement Act of 1988, Congress confirmed that Section 10(b) prohibits trading while in possession of material nonpublic information even when traders owe no duty to those with whom they trade. Section 20A of the Exchange Act, 15 U.S.C. § 78t-1 (1994), added to the Exchange Act by the 1988 Act, permits contemporaneous public security traders to recover from those who illegally trade securities while in possession of material nonpublic information. The mechanism it uses for this remedy again indicates that the prohibition extends to trading by those who owe no duty to those with whom they trade.

Section 20A was enacted in response to *Moss v. Morgan Stanley, Inc.*, in which the Second Circuit, which had already found that trading on the basis of misappropriated information violates Section 10(b) and Rule 10b-5, held that contemporaneous traders had no private right of action against those who trade on the basis of such information.[15] 719 F.2d 5,

15. *See* House Comm. on Energy and Commerce, Insider Trading and S.E.C. Fraud Enforcement Act of 1988, H.R. Rep. No. 100-910 at 26-27 (1988) [hereinafter House Report], *reprinted in* 1988 U.S.C.C.A.N. 6043, 6063-64 ("In particular, the codification of a right of action for contemporaneous traders is specifically intended to overturn court cases which have precluded recovery for plaintiffs where the defendant's violation is premised upon the misappropriation theory. *See, e.g., Moss v. Morgan Stanley*. . . ."). Many

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15-16 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984). Section 20A codified an explicit private right of action for contemporaneous traders against those who violate the Exchange Act or its rules and regulations by trading securities while in possession of material nonpublic information. Section 20A expressly provides for a private right of action for contemporaneous traders, but it does not say when trading is illegal. Instead it relied upon and incorporated what at that time was a unanimous judicial recognition that trading on the basis of misappropriated information was already illegal.[16] The

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commentators have recognized that Section 20A ratified the misappropriation theory. *See* D. Langevoort, *supra*, § 6.02, at 6-8 to 6-9 (1996); 8 L. Loss & J. Seligman, *supra*, at 3653 ("Presumably the adoption of § 20A resolves any lingering doubt as to whether there may be private rights of action to enforce the misappropriation theory."); Stuart J. Kaswell, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 Bus. Law. 145, 166-67 (1989); *see also SEC v. Clark*, 915 F.2d 439, 451-53 (9th Cir. 1990) (citing the 1984 and 1988 Acts in support of its decision to enforce the misappropriation theory); *United States v. Chestman*, 947 F.2d 551, 578 (2d Cir. 1991) (*en banc*) (Winter, J., concurring in part and dissenting in part) (suggesting that the 1984 Act "seems premised" on the validity of the misappropriation theory), *cert. denied*, 503 U.S. 1004 (1992); 8 L. Loss & J. Seligman, *supra*, at 3638 ("[B]oth in 1984 and in 1988 the House Committee on Energy and Commerce indicated in legislative reports preceding unanimous enactment of insider trading legislation that the misappropriation theory should be enforceable under § 10(b) and Rule 10b-5.").

16. *See* House Report, *supra*, at 10, *reprinted in* 1988 U.S.C.C.A.N. at 6047 ("Within the court-developed parameters for insider trading, courts that have addressed the issue have also broadened the doctrine of insider trading to include trading and tipping by persons who misappropriate material nonpublic information from sources other than market participants."); *id.* at 9-10, *reprinted in* 1988 U.S.C.C.A.N. at 6046-47 ("Under current case law, the SEC must establish that the person misusing the information breached either a fiduciary duty to shareholders or some other duty not to misappropriate insider information.").

mechanism that the 1988 Act used to create a private remedy for contemporaneous traders is predicated on the validity of the misappropriation theory.

B. Section 2 of the Insider Trading and Securities Fraud Enforcement Act of 1988 confirmed and codified that Rule 14e-3 is a valid and enforceable rule and that it is a violation of Section 10(b) and Rule 10b-5 to trade securities in the public securities markets based on material nonpublic information in breach of fiduciary duties.

In addition to establishing a private remedy against those who misappropriate material nonpublic information by trading in violation of their fiduciary duties, the Insider Trading and Securities Fraud Enforcement Act of 1988 explicitly established the validity of the misappropriation theory under Rule 10b-5 and of Rule 14e-3. Section 2 of the 1988 Act provides that

> The Congress finds that —
>
> (1) the rules and regulations of the Securities and Exchange Commission under the Securities Exchange Act of 1934 governing trading while in possession of material, non-public information are, as required by such Act, necessary and appropriate in the public interest and for the protection of investors;
>
> (2) the Commission has, within the limits of accepted administrative and judicial construction of such rules and regulations, enforced such rules and regulations vigorously, effectively, and fairly; and
>
> (3) nonetheless, additional methods are appropriate to deter and prosecute violations of such rules and regulations.[17]

These enacted findings directly address the questions presented by this case: the validity of the misappropriation theory under Rule 10b-5 and of Rule 14e-3. They establish that the SEC acted within its statutory authority in adopting the rules, and that the SEC had enforced those rules vigorously, effectively, and fairly within the limits of accepted administrative and judicial construction.

Section 2 of the 1988 Act is not a mere hortatory condemnation of insider trading. Instead, it states that the SEC's rules and regulations governing trading while in possession of material nonpublic information are within the rulemaking power conferred upon the SEC by the Exchange Act. The scope and limits of the SEC's rulemaking power are set by Section 14(e), by Section 23(a) of the Exchange Act, 15 U.S.C. § 78w(a) (1994), which provides the Commission shall have "power to make such rules and regulations as may be necessary or appropriate to implement the provisions" of the Exchange Act, and by Section 10(b), which makes it unlawful to violate "such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." Thus the Commission's insider-trading regulations are within its statutory rulemaking power if they are necessary or appropriate. Section 2(1) of the 1988 Act establishes that they are, specifically providing that the rules "governing trading while in possession of material, non-public information are, as required by [the Exchange] Act, necessary and appropriate in the public interest and for the protection of

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17. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 2, 102 Stat. 4677, 4677 (1988) (appended to 15 U.S.C. § 78u-1 (1994)).

investors." When the 1988 Act was adopted, the misappropriation theory and Rule 14e-3 had been upheld by every court that had considered them. Section 2 of the 1988 Act codified these decisions, and establishes that the SEC has acted within its authority in enforcing the misappropriation theory and Rule 14e-3.

The "rules and regulations . . . governing trading while in possession of material, non-public information" to which Section 2 of the 1988 Act refers are clearly Rules 10b-5 (particularly the misappropriation theory under Rule 10b-5) and 14e-3. Rule 14e-3 by its terms makes it unlawful for a person to trade securities while "in possession of material information . . . he knows or has reason to know is non-public," and is thus within the ambit of Section 2 of the 1988 Act. Rule 10b-5 also governs trading while in possession of material nonpublic information; indeed it is the primary rule that governs such trading. Although Rule 10b-5 does not speak in terms of "trading while in possession of material non-public information," by 1988 this Court had construed it to regulate such trading in *Chiarella* and *Dirks*, and it was "well known that the basic prohibitions against insider trading arise from judicial interpretations of the general anti-fraud provisions of Section 10(b) of the Exchange Act and rule 10b-5."[18] By 1988, the SEC and various United States attorneys had used Rule 10b-5 to enforce the misappropriation theory vigorously, and indeed until 1995 every court to consider the theory upheld it. Moreover, the reference to "accepted administrative and judicial construction" in Section 2(2) of the 1988 Act and the Act's legislative history both establish that the

18. Kaswell, *supra*, at 153. This Court has recognized that similar language in Secton 20A, which was added by the 1988 Act, refers to Rule 10b-5 to the extent that it governs trading while in possession of material nonpublic information. *See Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 360-61 (1991).

purpose of the 1988 Act was to validate the misappropriation theory as well as Rule 14e-3.[19]

Of course, no court has held Rule 10b-5 invalid, but the Eighth Circuit did hold that the SEC is without power under Section 10(b) to regulate trading on the basis of misappropriated information. However, the Commission does have power to regulate such trading because such regulation is, in the words of the statute, "necessary and appropriate." To negate any possibility that the misappropriation theory was beyond the SEC's regulatory power, Section 2 of the 1988 Act states that the rule under which the theory was enforced was within the SEC's rulemaking power and that the SEC's enforcement of that rule was appropriate. Indeed, the statutory standard that Section 2(1) of the 1988 Act says was satisfied — "necessary and appropriate in the public interest and for the protection of investors" — is the rule-making standard of Section 10(b).

In sum, by enacted statutes, Congress in 1984 made it unlawful and privately actionable for those in possession of material nonpublic information to trade options even when they owe no duty to those with whom they trade; in 1988 incorporated the misappropriation theory into the Exchange Act; and in 1988 declared that the SEC rules governing trading while in possession of material nonpublic information are authorized by the Exchange Act. Accordingly, the Eighth Circuit erred in

19. *See* House Report, *supra*, at 35, *reprinted in* 1988 U.S.C.C.A.N. at 6072 ("These findings are intended as an expression of congressional support for these regulations."); *id.* at 10-11, *reprinted in* 1988 U.S.C.C.A.N. at 6047-48; *see also* 134 Cong. Rec. E3078 (Sept. 23, 1988) (statement of Rep. Markey, principal author of the 1988 Act) ("One area in which there is strong congressional consensus is the validity of the 'misappropriation' theory of insider trading."). Shortly after the 1988 Act was enacted, the minority (Republican) counsel to the House Committee on Energy and Commerce wrote that the findings were enacted to assist the SEC in its efforts to bring insider trading cases. Kaswell, *supra*, at 157.

holding that the SEC had exceeded its authority in enforcing the misappropriation theory and adopting Rule 14e-3.

C. The 1988 Act's enacted declaration of long-standing congressional intent is entitled to substantial weight, even with respect to trades occurring before its enactment.

In his brief in opposition to the government's petition for writ of certiorari, respondent acknowledged that the 1988 Act "created a private cause of action for misappropriation."[20] This legislative action, as well as the 1988 Act's express declaration of the validity of the misappropriation theory and Rule 14e-3, indicate that the Eighth Circuit's decision should be reversed. Even though the respondent traded before the 1988 Act was enacted, the 1988 Act codified the well-established validity of the misappropriation theory and Rule 14e-3, and, as discussed below, the findings contained in Section 2 of the 1988 Act are entitled to significant weight in determining what Sections 10(b) and 14(e) meant even before it was enacted.[21]

Given that respondent's conduct predated the 1988 Act and that he apparently agrees that trading on the basis of misappropriated information has violated Section 10(b) since that Act was enacted, it would presumably be inappropriate in this case to hold that the misappropriation theory is not valid now, even if it was invalid before 1988. However, respondent's brief in opposition to the government's petition can also be read to suggest that Congress acted in 1988 because the misappropriation theory was not settled law, and that the 1988

20. *See* Respondent's Brief in Opposition to Petition for Writ of Certiorari at 20 (Jan. 17, 1997).

21. *See United States v. Winstar Corp.*, 116 S. Ct. 2432, 2463 (1996) ("Subsequent legislation declaring the intent of an earlier statute is entitled to significant weight.") (*quoting NLRB v. Bell Aerospace Co.*, 416 U.S. 267, 275 (1974)).

Act represents at most acquiescence in the misappropriation theory and not a binding statement of congressional intent.[22] These suggestions are incorrect. The 1988 Act codified the already established law that the misappropriation theory under Rule 10b-5 was valid and enforceable.

Amici are aware that congressional silence does not constitute binding acquiescence in erroneous lower court decisions.[23] However, the 1988 Act is precisely the opposite of congressional silence, and Section 2 of the Act codifies the validity of the misappropriation theory and Rule 14e-3 not by acquiescence but by express enactment. Similarly, the amendments to the Exchange Act enacted by the 1984 and 1988 Acts were premised on the continued validity of the misappropriation theory. Every court that had reviewed the misappropriation theory and Rule 14e-3 before 1988 had held them valid, and the structure of the 1988 amendments to the Exchange Act shows that Congress depended upon that precedent.

Amici also disagree with the proposition that because Congress codified the misappropriation theory as law in 1988, respondent cannot be punished for violating Section 10(b) before the 1988 Act was enacted. The misappropriation theory was well established by 1988, and indeed the 1988 Act was apparently structured as it was precisely because the validity of that theory and of Rule 14e-3 were established. To be sure, if there was ever any doubt about the status of the misappropriation theory and Rule 14e-3, the 1988 Act establishes their validity for conduct occurring after it was enacted. However, aside from

22. *See* Respondent's Brief in Opposition to Petition for Writ of Certiorari at 21-22, 26-27.

23. *See Central Bank v. First Interstate Bank*, 511 U.S. 164, 185-88 (1994).

the question of whether any new law the 1988 Act created would be retroactive, the 1988 Act's explicit, enacted declaration that the SEC acted within its power in adopting and enforcing its rules is in itself important evidence that the misappropriation theory and Rule 14e-3 were valid and enforceable before the 1988 Act was adopted.

As this Court recently noted, "[s]ubsequent legislation declaring the intent of an earlier statute is entitled to significant weight."[24] This Court has long recognized this principle.[25] In

24. *United States v. Winstar Corp.*, 116 S. Ct. 2432, 2463 (1996) (quoting *NLRB v. Bell Aerospace Co.*, 416 U.S. 267, 275 (1974)); *see also id.* at 2461-63 (citing 1987 statute's recognition of administrators' power to bargain away Congress's power to change the law to support finding that they had that power before the statute was enacted); *Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367, 380-82 (1969) ("Subsequent legislation declaring the intent of an earlier statute is entitled to great weight in statutory construction. And here this principle is given special force by the equally venerable principle that the construction of a statute by those charged with its execution should be followed unless there are compelling indications that it is wrong, especially when Congress has refused to alter the administrative construction. Here, the Congress has not just kept its silence by refusing to overturn the administrative construction, but has ratified it with positive legislation.") (citations omitted).

25. *See, e.g., Alexander v. Mayor & Commonalty of Alexandria*, 9 U.S. (5 Cranch) 1, 7-8 (1809) ("[A]cts *in pari materia* are to be construed together as forming one act. If in a subsequent clause of the same act provisions are introduced, which show the sense in which the legislature employed doubtful phrases previously used, that sense is to be adopted in construing those phrases. Consequently, if a subsequent act on the same subject affords complete demonstration of the legislative sense of its own language, the rule which has been stated, requiring that the subsequent should be incorporated into the foregoing act, is a direction to courts in expounding the provisions of the law. "); *see also Postmaster v. Early*, 25 U.S. 136, 148 (1827) (The words of the statute at issue "perhaps, manifest the opinion of the legislature, that the jurisdiction was in the Circuit Courts; but ought, we think, to be construed to give it, if it did not previously exist.").

addition to firmly establishing the validity of the misappropriation theory and Rule 14e-3, the 1984 and 1988 Acts constitute legislative statements that Congress understood them to be valid already, and these statements are entitled to respect. Section 2 of the 1988 Act, in particular, is a declaration that the misappropriation theory and Rule 14e-3 had always been within the SEC's power. Congress' confidence was well placed in light of the unanimity of contemporary precedent to the same effect, and its enacted statement is due special credence in light of this Court's repeated insistence that it is up to Congress to declare what is forbidden by the securities laws.[26]

CONCLUSION

The decision of the Eighth Circuit should be reversed.

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26. *See Central Bank v. First Interstate Bank*, 511 U.S. 164, 173 (1994); *Dirks v. SEC*, 463 U.S. 646, 657-58 (1983); *Chiarella v. United States*, 445 U.S. 222, 234 (1980); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 472 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976). In any event, if this Court determines that respondent's convictions for violating the securities laws should not be upheld, it should note that the misappropriation theory and Rule 14e-3 are now valid and enforceable.

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In The

Supreme Court of the United States

October Term, 1996

UNITED STATES OF AMERICA,

Petitioner,

vs.

JAMES HERMAN O'HAGAN,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF *AMICUS CURIAE* ASSOCIATION FOR INVESTMENT MANAGEMENT AND RESEARCH IN SUPPORT OF PETITIONER

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36 pp

TABLE OF CONTENTS

	Page
Table of Citations	ii
Interest of *Amicus Curiae*	1
Summary of Argument	3
Argument	4
I. A Clearly Defined Misappropriation Theory Will Give Guidance And Protection To Investment Analysts And Market Participants Generally. . .	6
A. Analysts Play A Vital Role In The Efficient Functioning Of The Market.	6
B. Uncertainty Concerning The Scope Of The Misappropriation Theory Chills The Free Flow Of Information.	11
C. This Court Should Clarify The Misappropriation Theory Based On The "Personal Gain" Principle Set Forth In *Dirks*.	12
II. This Court's Adoption And Articulation Of A Clearly Defined Misappropriation Theory Is Consistent With The Plain Language, Legislative History And Purpose Of Section 10.	18

Contents

	Page
A. The "Misappropriation Theory" Is Consistent With This Court's Prior Interpretations of the Statutory Language of Section 10(b).	18
B. Subsequent Congressional Actions Support (And May Be Read As Having Ratified) The Misappropriation Theory.	24
Conclusion	30

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Cases Cited:

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Central Bank of Denver N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 114 S. Ct. 1439 (1994) 11, 21

Chiarella v. United States, 445 U.S. 222, 100 S. Ct. 1108 (1980) 7, 16, 18, 20, 21, 22, 23, 25

Dirks v. SEC, 463 U.S. 646, 103 S. Ct. 3255 (1983) ..... *passim*

In re Cady, Roberts & Co., 40 S.E.C. 907 (1961) 16

In re Dirks, 47 S.E.C. 434 (1981) 9

Contents

	Page
Mills v. Electric Auto-Lite Co., 396 U.S. 375, 90 S. Ct. 616 (1970)	9
Moss v. Morgan Stanley, 719 F.2d 5 (2nd Cir. 1983) .	28
Red Lion Broadcasting Co. v. FCC, 395 U.S. 367, 89 S. Ct. 1794 (1969)	29
Rothberg v. Rosenbloom, 771 F.2d 818 (3rd Cir. 1985)	20
Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 97 S. Ct. 1282 (1977) 17, 21, 25
SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991), *cert. denied*, 502 U.S. 1071 (1992)	20
SEC v. Clark, 915 F.2d 439 (9th Cir. 1990)	20, 29
SEC v. Maio, 51 F.3d 623 (7th Cir. 1995)	12, 19
SEC v. Materia, 745 F.2d 197 (2nd Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985)	20
State Teachers Retirement Board v. Fluor Corp., 592 F. Supp. 592 (S.D.N.Y. 1984)	8
United States v. Bryan, 58 F.3d 933 (4th Cir. 1995) 11, 17, 20, 21, 24, 28, 29
United States v. Carpenter, 791 F.2d 1024 (2nd Cir. 1986), *aff'd*, 484 U.S. 19 (1987)	20, 27

Contents

Page

United States v. Chestman, 947 F.2d 551 (2nd Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992) 11, 13, 20, 24

United States v. Newman, 664 F.2d 12 (2nd Cir. 1981) 19, 20, 26

United States v. O'Hagan, 92 F.2d 612 (8th Cir.), *cert. granted*, 136 L. Ed. 2d 695, 65 U.S.L.W. 3505 (1996) 17, 18, 21, 28, 29

Statutes Cited:

Securities Exchange Act of 1934, Section 10(b), 15 U.S.C. § 78j(b) ..... *passim*

Insider Trading Sanctions Act of 1984 .... 16, 23, 25, 26, 29

Insider Trading and Enforcement Act of 1988 ..... 15, 26, 27, 28, 29

Rules Cited:

Rule 10b-5 ..... 8, 13, 16, 18, 20, 21, 28, 29

Rule 14e-3(a) 13

Supreme Court Rule 37 1

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Association for Investment Management and Research, FINANCIAL REPORTING IN THE 1990s AND BEYOND (1993) 10

Contents

Page

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FAF Guidelines on Inside Information, *Financial Analysts Journal*, January – February 1974 7

H.R. Conf. Rep. No. 94-229, 1 (1975) 13

H.R. Rep. No. 355, 98th Cong., 2nd Sess. 4 (1983), *reprinted in* 1983 U.S.C.C.A.N. 2274 ..... 17, 25, 26

H.R. Rep. No. 910, 100th Cong., 2d Sess. 10 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043 ..... 26, 27, 28

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S. Rep. No. 792, 73rd Cong., 2d Sess. 6 (1934) 13, 25

INTEREST OF *AMICUS CURIAE*

The Association for Investment Management and Research ("AIMR")[1] is a global, non-profit membership organization with more than 70,000 members and candidates worldwide. AIMR was formed in 1990 through the merger of the Financial Analysts Federation ("FAF") and the Institute of Chartered Financial Analysts ("ICFA"), organizations which have represented investment professionals since 1947. AIMR's members and candidates are securities analysts, portfolio managers and other investment decision-makers employed by investment management counseling firms, banks, broker-dealers, mutual fund complexes, pension fund consultants, and insurance companies. Directly and through their employers, AIMR members and candidates manage more than six trillion dollars in assets worldwide. AIMR also sponsors the Chartered Financial Analyst ("CFA") designation program. The CFA charter is an internationally recognized credential certifying the highest achievement in the investment profession.

AIMR members must comply with the Association's *Code of Ethics* and *Standards of Professional Conduct*. *See* ASSOCIATION FOR INVESTMENT MANAGEMENT AND RESEARCH, STANDARDS OF PRACTICE HANDBOOK (7th ed. 1996) ("HANDBOOK"). Since first promulgated in 1962, the *Standards of Professional Conduct* applicable to AIMR's members have prohibited the use of material, nonpublic information, including misappropriated information. Presently, the relevant standard states:

> Members who possess material non-public information related to the value of a security

---

1. Counsel for a party did not author this brief in whole or in part and no person or entity, other than the *amicus curiae*, its members, or counsel, have made a monetary contribution to the preparation or submission of the brief. Pursuant to Rule 37 of the Rules of the Court, the parties have consented to the filing of this brief. Their letters of consent have been filed with the Clerk of the Court.

> shall not trade or cause others to trade in that security if such trading would breach a duty or if the information was misappropriated or relates to a tender offer. If members receive material non-public information in confidence, they shall not breach that confidence by trading or causing others to trade in securities to which such information relates. Members shall make reasonable efforts to achieve public dissemination of material non-public information disclosed in breach of a duty.

HANDBOOK, Standard V(A), p. 141. Through its Professional Conduct Program, AIMR promotes and maintains the highest professional standards for its members and the investment industry.

As investment professionals, AIMR's members have a substantial interest in the development of the regulation of insider trading matters, which impact their daily activities in the securities markets. AIMR and its predecessor organizations have long supported efforts to prohibit insider trading and the misuse of material, nonpublic information, believing these efforts are necessary to maintain investors' confidence in the integrity of the markets. AIMR believes that the misappropriation theory is an essential tool in the regulation of improper insider trading activity. Any AIMR member who misappropriates material, nonpublic information and uses it as the basis for a securities recommendation or transaction violates the AIMR Standards of Conduct, regardless of whether the member owes a duty to the shareholders of the company, the member's employer, or any other person or entity. HANDBOOK, p. 174.[2]

In supporting efforts to prohibit insider trading, AIMR has

2. The Standard applies to members of AIMR who directly misappropriate material nonpublic information. *See* HANDBOOK, p. 174.

consistently emphasized the importance of protecting the legitimate exchange of information between corporations and securities analysts. The free flow of such information is crucial to the efficient functioning of the U.S. capital markets. As the primary professional association representing analysts and other investment practitioners, AIMR is an interested party in the case and AIMR requests the Court ratify the misappropriation theory of insider trading liability. In so doing the Court should clearly define the parameters of the theory to ensure the continued protection of the valuable role of investment professionals in the securities markets under the principles set forth in *Dirks v. SEC*, 463 U.S. 646, 103 S. Ct. 3255 (1983).

SUMMARY OF ARGUMENT

AIMR supports approval of the "misappropriation theory" of insider trading liability, and urges the Court to define the requirements and reach of the theory as clearly as possible. To reach the type of undesirable conduct which Section 10(b) of the Securities Exchange Act of 1934 (the "Act"), 15 U.S.C. § 78j(b), sought to prohibit, while ensuring the free flow of information needed by market analysts, the misappropriation theory must be clearly defined. While bright-line rules are understandably difficult to craft when dealing with the myriad of settings in which nonpublic information may be obtained, AIMR believes that such a test is critical to allow analysts to function efficiently in the market, benefiting all investors. The absence of a bright-line test has a chilling effect on the free flow of information which hinders the analyst's ability to make informed decisions concerning the value of the securities of a corporation. This, in turn, reduces the amount of information available to the market, harming investors. AIMR advocates a bright-line test holding that the disclosure of material, nonpublic information to or by an analyst violates Section 10(b) only if the disclosure is for **personal gain,** such as pecuniary gain or reputational benefit that would translate to future earnings or use of the information as gifts to friends or relatives. AIMR

believes this approach would create greater certainty; facilitating the free flow of information while allowing the SEC to reach undesirable conduct in the market.

The adoption of such a "misappropriation theory" is consistent with the plain language of Section 10(b) of the Act as well as Congressional intent reflected in more recent amendments to the securities laws, which can be fairly said to have ratified the misappropriation theory developed in the lower federal courts. This is an appropriate case — concerning an egregious misuse of confidential information by an attorney — for this Court to confirm that misappropriation of material, nonpublic information is unlawful.

ARGUMENT

Under the classical theory of insider trading liability as developed by this Court, a person is liable for trading on material, nonpublic information under Section 10(b) of the Act if:

(i) he owes a fiduciary or similar duty to the other party to the transaction;

(ii) he is an insider of the company in whose shares he trades and thus owes a fiduciary duty to the company's shareholders; or

(iii) he is a tippee who received his information from an insider of the company and knows, or should know, that the insider breached a fiduciary duty in disclosing the information to him.

The classical theory of liability, which requires that a duty be owed to the company whose shares are traded, does not regulate important instances of manipulative or deceptive

practices in connection with the purchase and sale of securities.[3] The misappropriation theory was developed to cover those gaps in the classical theory where trading in material, nonpublic information violated a fiduciary or similar duty, irrespective of whether the duty was owed to the company whose securities were traded.

Without an effective theory of liability to combat such fraud, the integrity of the market for securities necessarily suffers and investors are harmed. Thus, AIMR believes that a clearly stated misappropriation theory is a proper exercise of judicial authority which is vital to the effective regulation of improper insider trading. In this brief *amicus curiae*, AIMR first discusses the importance of the analyst's role, the benefits of a free flow of information and the need for clarity in this area. In the second part, AIMR submits that the misappropriation theory is valid under Section 10(b) of the Act.

3. For example, the classical theory does not extend to:

(i) trading on material nonpublic information by outsiders (i.e., persons who are neither insiders of the company whose shares are being traded nor tippees of such insiders);

(ii) transactions in the securities of proposed acquired companies by insiders of the acquiring company, including officers, directors, investment bankers and the like;

(iii) transactions in securities of suppliers and other companies about which corporate or government officials have material information;

(iv) transactions in securities by brokerage and investment advisory firm employees in companies which are the subject of unpublished research reports;

(v) transactions in securities by employees on the basis of information stolen from employers as long as such information does not relate to the employer's own securities; or

(vi) transactions on the basis of inside information by officers, directors and other insiders in debt securities issued by their own companies.

I. A CLEARLY DEFINED MISAPPROPRIATION THEORY WILL GIVE GUIDANCE AND PROTECTION TO INVESTMENT ANALYSTS AND MARKET PARTICIPANTS GENERALLY.

A. Analysts Play A Vital Role In The Efficient Functioning Of The Market.

Securities analysts and investment managers function in a variety of contexts in the securities industry through their work for broker-dealers, banks, investment advisers, mutual fund complexes, insurance companies, pension funds and other employers. A financial analyst must gather and interpret large quantities of information from many sources; success requires diligent information gathering, analytical skill and a sensitive intuition. The analyst is often active in "ferreting out" relevant information. Analysts typically search for, assemble and evaluate information about companies and their securities, and issue reports and investment recommendations to individual and institutional investors. Investment managers utilize the research of analysts, as well as their own investment experience and analyses, in making investment decisions on behalf of their clients and employers.

An analyst must make judgments regarding the economy as a whole, as well as the prospects of a particular industry. Beyond an understanding of macroeconomic factors, an analyst must examine the individual characteristics of the companies being followed. For example:

> Foreign exposure, competitiveness of product lines, pricing flexibility, efficiency, cost controls, tax rates, financial position, accounting practices and the historical financial record are only a few of the variables that differentiate companies. The analyst combines his understanding of these

> many dynamic variables to estimate, among other key factors, future earnings and dividends. . . . Even after estimating future earnings and dividends, [the analyst] must assess the price at which a security may sell. The price/earnings ratio contributes importantly to the variability of a particular security's price, and as a part of his work the financial analyst must make this essential value judgment.

FAF Guidelines on Inside Information, *Financial Analysts Journal*, January – February 1974.

This Court recognized the value of the analyst's position in the marketplace in *Dirks v. SEC*, 463 U.S. 646, 103 S. Ct. 3255 (1983). In *Dirks*, this Court considered whether an analyst, who had received material, nonpublic information from insiders concerning fraud and had broadly disseminated that information, had violated Section 10(b). *Id.* This Court in *Dirks* found he had not, reaffirming the holding set forth in *Chiarella v. United States*, 445 U.S. 222, 100 S. Ct. 1108 (1980), that insider trading liability should not result "merely from one's ability to acquire information because of his position in the market." *See Dirks*, 463 U.S. at 658 (citing *Chiarella*, 445 U.S. at 232-33 n. 14). This Court specifically found:

> Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. It is commonplace for analysts to "ferret out and analyze information" . . . and this often is

> done by meeting with and questioning corporate officers and others who are insiders. And information that analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analyst's judgment in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or to the public generally.

Id. at 658-59 (citations omitted). *See also State Teachers Retirement Board v. Fluor Corp.*, 592 F. Supp. 592, 594 (S.D.N.Y. 1984) ("[b]ecause the incentive to gather market information derives from the ability of traders to use that information profitably, the Court in *Dirks* was loathe to find that the mere possession and use of nonpublic, material information amounted to a 10b-5 violation. Such restrictions could have restrained the endeavors of market analysts, whose inquiries are 'necessary to the preservation of a healthy market' ") (quoting *Dirks*, 463 U.S. at 658).

The analyst's crucial role in the market also has been recognized by the SEC. The SEC has stated that the analyst's role is invaluable to investors generally:

> The value to the entire market of these efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by such initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors.

In re Dirks, 47 S.E.C. 434, 441 (1981) (citations omitted) (cited in *Dirks*, 463 U.S. at 659 n. 17). The continuing vitality of these principles in the securities markets in 1997 is beyond question. The role of the analyst in the market continues to be a critical one worthy of acknowledgment and protection from this Court.

Essential to the practice of financial analysts is the free flow of information. *See Dirks*, 463 U.S. at 658. *See also* Note, *Securities Regulation – Dirks v. SEC: Tippee Liability After Chiarella v. United States*, 59 TUL. L. REV. 502, 515 n. 44 (1984) ("The Court [in *Dirks*] indicated that market analysts deserved particular freedom due to their role in analyzing and disseminating corporate information disclosed in compliance with the securities acts."). For the fair and efficient operation of the capital markets, analysts and investors must have the maximum amount of information possible to facilitate well-informed decisions about how and where to invest capital. These disclosures must go beyond the information mandated by the reporting requirements of the federal securities laws and should extend to specific business information about matters relevant to a company's future growth, such as new products, capital projects and the competitive environment. Analysts seek and use such information to compare and contrast investment alternatives.

Nor is the analyst's role a passive one. A successful analyst works to uncover information concerning a company, increasing the amount of information available to the market as a whole. Indeed, the private efforts of analysts in digging up information relevant to the market is an important supplement to the public disclosures required by the securities laws. *Cf.*, *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 382, 90 S. Ct. 616, 620 (1970) (pointing out that private enforcement of the proxy rules under the Act provided a necessary supplement to SEC action).

Analysts often receive such information through contacts

with corporate insiders, especially investor relations and finance officers. Information may be disseminated in the form of press releases, through oral presentations by company executives in analysts' meetings or conference calls, or during analysts' visits to company premises. *See* ASSOCIATION FOR INVESTMENT MANAGEMENT AND RESEARCH, FINANCIAL REPORTING IN THE 1990s AND BEYOND (1993). Analysts also reach beyond contacts with companies themselves to sources such as customers, contractors, suppliers and competitors in seeking to develop the most accurate and complete picture of a company.

Another important tool for the analyst is the use of the "mosaic theory" in analyzing a company. The "mosaic theory" has come to describe the process by which an analyst may use a significant conclusion derived from perceptive analysis of public information and nonmaterial, nonpublic information as the basis of a securities recommendation or transaction. This process of reaching a recommendation should not give rise to insider trading liability, even if the conclusion derived would have constituted restricted material, nonpublic information had it been communicated directly to the analyst by an insider. An example would be an analyst concluding that a merger was likely between two public companies based on a variety of information which forms a pattern or "mosaic." This conclusion would not be subject to insider trading liability, under the "classical" or "misappropriation" theory, even if the news of a likely merger, if received directly, would be unlawful.

All of these crucial activities, which form the basis of the analysts' opinions and recommendations, require the free flow of information without the fear of action by the SEC. Indeed, AIMR cannot overemphasize the importance of such exchanges of information to its membership and the efficient functioning of the market.

B. Uncertainty Concerning The Scope Of The Misappropriation Theory Chills The Free Flow Of Information.

Because of the relative dearth of judicial opinions pertaining to analysts in the insider trading context, the exercise of analytical function and the free flow of information are sometimes chilled by uncertainties in the law. *See* John C. Coffee, Jr., "Disclosures to Analysts are Risky," *National Law Journal* (Feb. 1, 1993) at A20 (among the negative consequences of chilling the discourse between analysts and corporations is the increased likelihood that the market will be more frequently "surprised" by announcements which depart from analysts' forecasts). As this Court stated in *Dirks*, "[w]ithout legal limitations, market participants are forced to rely on the reasonableness of the SEC's litigation strategy, but that can be hazardous, as the facts of this case make plain." *Dirks*, 463 U.S. at 664 n. 24. *See also Central Bank of Denver N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, __, 114 S. Ct. 1439, 1454 (1994) (the securities market "demands certainty and predictability"); *United States v. Bryan*, 58 F.3d 933, 950 (4th Cir. 1995) ("[a]bsent clearly defined rules, investors find themselves the target of *ad hoc* decisionmaking or pawns in an overall litigation strategy known only to the SEC."); *United States v. Chestman*, 947 F.2d 551, 567 (2nd Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992) (recognizing that without clear guidelines, "efforts to construe Rule 10b-5 [could] lose method and predictability, taking over 'the whole corporate universe'. . .") (citations omitted).

Uncertainty regarding the breadth of the misappropriation theory inhibits the exchange of information between investment professionals and the companies they analyze, as well as other valuable sources who have a relationship to the company. For example, analysts often seek information from a company's customers and suppliers in evaluating its business prospects and

financial status. The flow of information should not be chilled by uncertainty as to the nature of the relationship that the analyst's source has with the company. Absent the sort of "tipping for personal benefit" referred to by the Court in *Dirks*, an analyst should be permitted to use the information derived from such contacts without fear of liability for insider trading. Without a bright-line test, market participants are forced to define the SEC's enforcement strategy before they can be confident that the exchange of information is permissible.

C. This Court Should Clarify The Misappropriation Theory Based On The "Personal Gain" Principle Set Forth In *Dirks*.

As set forth above, AIMR has long recognized that insider trading regulation is necessary to ensure the perception of integrity which is critical to investor confidence in the capital markets. The "classical theory" of insider trading reaches persons who trade on the stocks of the company of which they are insiders, while in possession of material, nonpublic information. In contrast, the misappropriation theory reaches persons who trade on material, nonpublic information for their own personal gain, even if they are not insiders of the company in whose stock they traded. *See SEC v. Maio*, 51 F.3d 623, 631 (7th Cir. 1995). AIMR believes that the misappropriation theory is a valid exercise of judicial authority which constitutes a crucial aspect of the insider trading prohibition and should be endorsed by this Court. *See* Barbara Bader Aldave, *The Misappropriation Theory: Carpenter and Its Aftermath*, 49 Ohio St. L.J. 373, 379 (1988) (noting that the victims of trading on the basis of misappropriated information are other members of the investing public who were induced by the fraudulent misappropriator's trading to buy or sell on unfavorable terms or were preempted by the misappropriator's trading from buying or selling on favorable terms). The misappropriation theory effectuates the legislative purposes of the anti-fraud provisions "to assure that dealing in securities is fair and without undue preferences or

advantages among investors," H.R. Conf. Rep. No. 94-229, p. 91 (1975), and to prohibit "those manipulative and deceptive practices which have been demonstrated to fulfill no useful function." S. Rep. No. 792, 73rd Cong., 2d Sess. 6 (1934).

In the absence of the misappropriation theory, an imbalance in access to information inevitably will result, discouraging less informed investors from entering the market. In addition, the research and analysis function performed by investment professionals will be devalued as investors perceive the market to be "rigged" in favor of those who possess material, nonpublic information. The theory is consistent with the plain language and intent of Congress, as set forth below, and as found by most of the lower courts which have considered the question.

While AIMR urges the ratification of the misappropriation theory, we respectfully request that this Court clarify the parameters of the theory, in order to facilitate its future application. Although a bright-line test is understandably difficult to craft when dealing with the myriad of settings in which nonpublic information may be obtained and used, Rule 14e-3(a) is an example of an effective clearly-drawn regulation in the securities context.[4] AIMR believes that the inquiry as to whether certain acts have violated Section 10(b) through misappropriation of information should center on whether the material, nonpublic information is used for the "personal gain" of either the outside source of the information or the analyst.

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4. *See Chestman*, 947 F.2d at 557 (describing Rule 14e-3(a) "[Rule 14e-3(a) is a disclosure provision. It creates a duty in those traders who fall within its ambit to abstain or disclose, without regard to whether the trader owes a pre-existing fiduciary duty to respect the confidentiality of the information."). AIMR agrees with the analysis of the Second Circuit in *Chestman* that Rule 14e-3(a) is validly adopted by the SEC, independent of whether the "misappropriation theory" is upheld under Section 10(b). AIMR would also support an SEC Rule to clarify the scope of the misappropriation doctrine under Section 10(b).

In crafting this test, AIMR respectfully asks that the Court take special note of the unique role of the analyst in the market.

This Court should reiterate that the protections afforded to analysts in *Dirks* are as fully applicable to a "misappropriation theory" of insider trading liability as they are to "classical" insider trading. Thus, an analyst who is receiving material, nonpublic information from a noninsider source but neither knows nor reasonably should know that the source has misappropriated the information for "personal gain," should be free to utilize that information. In addition, the Court should clarify that a noninsider source, such as a customer, competitor or supplier, would not be subject to liability under the misappropriation theory for providing material, nonpublic information to an analyst if such communication is not made for personal gain. Of course, consistent with AIMR standards, the active misappropriation of material, nonpublic information by an analyst, such as the unauthorized reading or copying of company documents, would be illegal under the misappropriation theory as advocated by AIMR.

This Court addressed the meaning of personal gain in *Dirks*, where personal gain was defined as the receipt of "a direct or indirect personal benefit from the disclosure, such as pecuniary gain or reputational benefit that will translate into future earning." *Dirks*, 463 U.S. at 663. Additionally, this Court noted that a gift of confidential information to a relative or friend who then trades on it may be considered a personal benefit. *Id.* at 664. AIMR also has defined "personal benefit" in a similar fashion; the AIMR Standard states:

> The personal benefit to the insider is often financial, but a breach of duty may also be found in the following circumstances:
>
> - the tipper's reputation in the financial community is enhanced by the disclosure;

> - a relationship exists between the insider and the tippee that suggests a quid pro quo from the insider to the tippee;
>
> - the insider makes a "gift" of confidential information to a friend or relative.

HANDBOOK, p. 171.

The extension of *Dirks*' protection of analysts is also consistent with the SEC's suggestion, in 1987, of a safe harbor for analysts in connection with the proposed codification of the misappropriation theory. The SEC proposed a special exemptive provision for communications by analysts in the regular course of business or to analysts whose communications were not made for "personal benefit."[5]

---

5. The proposed language of the exemptive provision excluded:

> any communication made:
>
> (A) in the ordinary course of business by a person engaged in the business of analyzing and disseminating information concerning securities, the market for securities, or the financial condition of issuers; or
>
> (B) to a person engaged in . . . [that same business], if such communication is not made for the personal benefit of the person making the communication.

Donald C. Langevoort, *Investment Analysts and The Law of Insider Trading*, 76 VA. L. REV. 1023, 1035-1036 (1990). The SEC eventually agreed to a so-called reconciliation draft of legislation which dropped the explicit safe-harbor for the analyst. However, the SEC's support of the reconciliation draft was dependent on the inclusion in the legislative history of language designed to assure that the legislation would not threaten the legitimate activities of investment analysts. *Id.* at 1036. As discussed more fully below, *see* pp. 20-24 *infra*, Congress did not codify the misappropriation theory but clearly indicated its support for the theory and ratified the misappropriation theory in the Insider Trading and Enforcement Act of 1988.

Focusing the inquiry on whether a person has violated Section 10(b) and Rule 10b-5 on whether dissemination of material nonpublic information was for personal gain, is consistent with this Court's analysis in *Dirks*. In describing the standard for determining whether a party had engaged in insider trading, the Court stated:

> [I]n determining whether the insider's purpose in making a particular disclosure is fraudulent, the SEC and the courts are not required to read the parties' minds . . . [rather] [t]his requires courts to focus on objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as pecuniary gain or reputational benefit that will translate into future earnings.

Dirks, 463 U.S. at 663. *See also Chiarella*, 445 U.S. 222, 242 (in crafting the misappropriation theory Justice Burger emphasized "[l]ikewise, market specialists would not be subject to a disclose-or-refrain requirement in the performance of their every day market functions. . . . [;] trading is accomplished on the basis of material, nonpublic information, but the information has not been unlawfully converted **for personal gain**") (emphasis added); *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 n. 15 (1961) (one purpose of the securities laws was to eliminate the use of inside information **for personal advantage**).

A focus on personal gain also is consistent with Congress's interpretation of Section 10(b) in considering the enactment of the Insider Trading Sanctions Act of 1984 (the "1984 Act"). The House Report accompanying the legislation clearly established that Congress considered the misappropriation theory a valid interpretation of Section 10(b) and stated:

> in certain widely publicized instances, agents of tender offerors and persons contemplating a merger or acquisition have used for personal gain information entrusted to them solely for a business purpose. Such conversion **for personal gain** of information lawfully obtained abuses relationships of trust and confidence and is no less reprehensible than the outright theft of nonpublic information.

H.R. Rep. No. 355, 98th Cong., 2nd Sess. at 4-5 (1983) (emphasis added).

As noted in *Dirks* the emphasis on whether the information was used for personal gain, rather than only the amorphous concept of the existence of a fiduciary duty or similar relationship of trust, provides the courts with an "objective criteria" for determining whether the disclosure of material, nonpublic information was a violation of Section 10(b). The existence of an objective criteria for making this determination, as well as a relatively bright-line test concerning the responsibilities of analysts and their sources, will encourage the free flow of information to analysts so necessary for the efficient functioning of the market while providing the SEC with sufficient authority to reach "those manipulative and deceptive practices which have been demonstrated to fulfill no useful function'," *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 474 n. 13, 97 S. Ct. 1282, 1391 n. 13 (1977).[6]

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6. Even courts which refused to apply the misappropriation theory have vehemently condemned the behavior of the misappropriator. *See Bryan*, 58 F.3d at 959 ("[o]ur rejection of the misappropriation theory certainly should not be taken as approval of the kind of conduct of which Bryan was convicted, not should it be perceived as evidencing a view that such conduct is not properly the subject of criminal liability."); *United States v. O'Hagan*, 92 F.2d 612, 628 (8th Cir.), *cert. granted*, 136 L. Ed. 2d 695, 65 U.S.L.W. 3505 (Cont'd)

II. THIS COURT'S ADOPTION AND ARTICULATION OF A CLEARLY DEFINED MISAPPROPRIATION THEORY IS CONSISTENT WITH THE PLAIN LANGUAGE, LEGISLATIVE HISTORY AND PURPOSE OF SECTION 10.

A. The "Misappropriation Theory" Is Consistent With This Court's Prior Interpretations Of The Statutory Language Of Section 10(b).

Seventeen years after itself planting the seeds for the "misappropriation theory" in individual opinions in *Chiarella v. United States*, 445 U.S. 222, 100 S. Ct. 1108 (1980), this Court now squarely faces whether the theory is valid in its review of James O'Hagan's conviction. The theory upon which his conviction rests — the "misappropriation theory"— is consistent with both the plain language of Section 10(b) of the Act and this Court's prior interpretations of the statute.

In *Chiarella*, this Court set forth the "classic theory" of insider trading liability, finding that an obligation to disclose material nonpublic information or abstain from trading attaches to corporate insiders based on "(i) the existence of a relationship affording access to inside information to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure." *Chiarella*, 445 U.S. at 227. However, Justice

(Cont'd)
(1996) ([o]ur ruling today should in no manner be understood as condoning O'Hagan's conduct. From the record, it appears as though O'Hagan, then an attorney, engaged in at least some transactions in Pillsbury securities after learning privileged, confidential information that his law firm was representing a client intending a takeover of Pillsbury. Such conduct is certainly unethical and immoral and must be condemned, which we hasten to do."). Under the "personal gain" test, both Bryan and O'Hagan would be guilty of violating Section 10(b) and Rule 10b-5, a result which clearly comports with the purpose of the statute.

Stevens and Justice Brennan in concurring opinions, and Chief Justice Burger in his dissent, each articulated a theory of liability based not on Chiarella's breach of duty to the target company's shareholders, but rather on his breach of fiduciary duty owed to his own employer, from whom he had misappropriated the information, and the acquiring corporation that had hired it. These opinions formed the basis for the development of the misappropriation theory of liability under Section 10(b).

The misappropriation theory expands the reach of Section 10(b) to outsiders and their tippees. Under the misappropriation theory, a person trading on material nonpublic information improperly obtained from an outsider violates Section 10(b). Thus, the misappropriation of material, nonpublic information from its lawful possessor is regarded as a sufficient breach of fiduciary duty 'in connection with' the purchase or sale of a security to justify liability under Section 10(b). *See Maio*, 51 F.3d at 631.

The Second Circuit was the first circuit to adopt the misappropriation theory. In *United States v. Newman*, 664 F.2d 12 (2nd Cir. 1981), the government brought criminal charges for a violation of Section 10(b) against two employees of separate investment banks who misappropriated confidential information regarding pending tender offer targets and then conveyed that information to Newman and two other traders who purchased stock in the target companies. Noting that this Court had left open the question whether the misappropriation of confidential information constitutes fraud for purposes of Rule 10b-5, the *Newman* court held that the appellants' theft of valuable non-public information from their employers was sufficient to constitute fraud for purposes of the rule, and reasoned that by sullying the reputation of the investment banks as safe repositories of client confidences, the appellants fraudulently deprived their employers of value "just as surely as if they had stolen cash or securities." *Newman*, 664 F.2d at

17 (citations omitted). The court found that the fraud was "in connection with" the purchase and sale of the securities because the appellants' "sole purpose" in misappropriating confidential information was to purchase shares of target companies. *Newman*, 664 F.2d at 18.

The Second Circuit's decision in *Newman* adopted the "fraud on the source" version of the misappropriation theory discussed by Justice Stevens in his concurring opinion in *Chiarella*. As refined by further decisions, the theory generally provides that Section 10(b) and Rule 10b-5 thereunder are violated when a person:

(i) misappropriates material non-public information,

(ii) by breaching a duty arising out of a relationship of trust and confidence, and

(iii) uses that information in a securities transaction,

(iv) even though he or she owed no duty to the shareholders of the traded stock. *See SEC v. Clark*, 915 F.2d 439, 443 (9th Cir. 1990).

This fraud on the source theory has been developed in a series of other Second Circuit decisions, (*see, e.g., SEC v. Materia*, 745 F.2d 197 (2nd Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985); *United States v. Carpenter*, 791 F.2d 1024 (2nd Cir. 1986), *aff'd*, 484 U.S. 19 (1987); *United States v. Chestman*, 947 F.2d 551 (2nd Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992)), and has been adopted by the Third (*see, e.g., Rothberg v. Rosenbloom*, 771 F.2d 818, 822 (3rd Cir. 1985)), Seventh (*see, e.g., SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991), *cert. denied*, 502 U.S. 1071 (1992)), and Ninth (*see, e.g., SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990)) Circuits. Until the Fourth Circuit's decision in *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995),

which the court below relies on heavily, the validity of the misappropriation theory under Section 10(b) had been uniformly recognized by the lower courts.

This Court should restore that uniformity by upholding the "misappropriation theory" as valid under Section 10(b). The statutory language, of course, must start the analysis as no agency rule or theory of liability can go beyond the Act. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, __, 114 S. Ct. 1439, 1444 ("the scope of conduct prohibited by Section 10(b) [is controlled] by the text of the statute"); *Chiarella*, 445 U.S. at 234 ("the 1934 Act cannot be read more broadly than its language and the statutory scheme reasonably permit.") It is now well-established that a violation of Section 10(b) or Rule 10b-5 requires conduct involving manipulation or deception, and that the fraud be "in connection with the purchase or sale of any security." *Santa Fe*, 430 U.S. at 473.

The Eighth Circuit, we respectfully suggest, reads these requirements too narrowly to demand "a particularized showing of misrepresentation or nondisclosure," *O'Hagan*, 92 F.2d at 618, to the other party in a securities transaction. The plain language of Section 10(b) does not limit its reach to fraudulent misrepresentations or omissions directed to the seller or purchaser of a given security. Congress chose the more expansive construction of prohibiting manipulative or deceptive conduct against any person as long as such conduct arose in connection with the sale or purchase of securities.[7]

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7. Both the *Bryan* and *O'Hagan* courts found that the improper conduct sought to be reached under the misappropriation theory was adequately addressed by federal criminal mail and wire fraud statutes and state fraud

(Cont'd)

Nor do the Court's most applicable precedents preclude adoption of a clearly articulated misappropriation theory. In *Chiarella*, this Court declined to reach the issue because the jury had not been instructed on the theory. Accordingly, the language in *Chiarella* regarding "parties to a transaction" should not be interpreted as deciding the very issue the Court expressly reserved to a later day. *Chiarella*, 445 U.S. at 236. The misappropriation theory is also consistent with the Courts' holding in *Dirks* that an "insider will be liable under Rule 10b-5 only where he fails to disclose material nonpublic information before trading on it [in violation of a duty to disclose or abstain] and thus makes 'secret profits.' " *Dirks*, 463 U.S. at 654. In fact, in exonerating Dirks, the Court expressly noted that "there was no expectation by Dirks' source that he would keep their information in confidence. **Nor did Dirks misappropriate or illegally obtain the information about Equity Funding.**" *Id.* at 666 (emphasis added).

Likewise, in *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 105 S. Ct. 2622 (1985), a case in which the Court addressed the common law *in pari delicto* defense in Section 10(b) actions, the Court stated in dicta that "we have also noted that a tippee may be liable if he misappropriate[s] or illegally obtains . . . information." *Id.* at 313 n. 22 (citing *Dirks* and the

(Cont'd)
law. This argument is problematic in several respects. Indeed, since the SEC has no authority to bring actions under the federal mail and wire fraud statutes, which are general criminal statutes, it is questionable whether it would have the authority to even investigate possible insider trading offenses involving only misappropriated information. Thus, neither the SEC nor any other federal agency would have authority to bring civil insider trading cases under the misappropriation theory. As the SEC is the principal agency responsible for protecting investors and the integrity of the market, it would have insufficient enforcement authority to reach conduct which threatens securities markets in these areas. Lastly, securities markets are global in character and state law cannot be depended on to consistently and adequately regulate prohibited conduct in those markets.

legislative history of the Insider Trading Sanctions Act of 1984). O'Hagan's conviction in particular, and the misappropriation theory in general, do not rest on liability imposed "merely from one's ability to acquire information because of his position in the market," *Dirks*, 463 U.S. at 657, but rather on the misuse of that information in the market for one's own personal gain. O'Hagan's actions go to "the heart of what the securities laws are intended to prohibit." *Chiarella*, 445 U.S. at 246 (Blackmun J., dissenting).

This Court's decision in *Dirks* contemplates that liability for insider trading would at least extend to individuals such as O'Hagan who may be considered "temporary insiders." In considering the scope of insider trading liability, this Court observed that fraud, referring to manipulation or deception, "derives from the inherent unfairness involved where one takes advantage" of "information intended to be available only for a corporate purpose and not for the **personal benefit** of anyone." *Dirks*, 463 U.S. at 654 (emphasis added). In reiterating that under the deceptive prong of Section 10(b), liability for trading on insider information was premised on the use of material information for personal benefit, rather than the benefit of the corporation, the Court noted:

> Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are **given access to**

> **information solely for corporate purposes. . . .**

Id. at 677 n. 14 (emphasis added).

O'Hagan would, in fact, be liable under the "classical theory" of insider trading but for the fact that he bought Pillsbury call options and common stock rather than the securities of Grand Met. It would be anomalous if the securities laws' reach to O'Hagan depended on whether he traded in Pillsbury securities and options rather than those of Grand Met. Indeed, purchase of the target's securities, such as Pillsbury, on the basis of insider information could drive up the price of the target's securities and thus be more harmful to Grand Met than trading in its own stock based on insider information.

The lower courts have recognized that "temporary insider" liability is a tacit recognition of the misappropriation theory in a limited context. *See Chestman*, 947 F.2d at 566 (finding that the temporary insider theory of prosecution might well have covered the activities of some persons found guilty under the misappropriation theory). Even the court in *Bryan* conceded that many of the people who would fall within the ambit of the misappropriation theory had a recognized obligation to disclose or abstain from trading, such as underwriters, accountants, lawyers or consultants working for a corporation. *Bryan*, 58 F.3d at 953. AIMR strongly believes that O'Hagan as a temporary insider, as defined by *Dirks*, had a duty to disclose or abstain from trading in the stock of any company to which his insider information related.

B. Subsequent Congressional Actions Support (And May Be Read As Having Ratified) The Misappropriation Theory.

In enacting Section 10(b), Congress sought to prohibit "those manipulative and deceptive practices which have been

demonstrated to fulfill no useful function." S. Rep. No. 792, 73rd Cong. 2d Sess. (1934). *See also Santa Fe*, 430 U.S. at 477, 478 (the fundamental purpose of the 1934 Act is "to substitute a philosophy of full disclosure for the philosophy of caveat emptor.") (citations omitted). Congress has on two separate occasions since this Court's decision in *Chiarella* and *Santa Fe* expressly endorsed the misappropriation theory as reaching the type of manipulative and deceptive practices proscribed by Section 10(b). AIMR believes that Congress's approval of the theory since this Court's *Chiarella* and *Dirks* decisions is an important factor in determining whether the theory satisfies the "deception" and "in connection with" requirements of Section 10(b). *See Bateman Eichler, Hill, Richards, Inc. v. Berner*, 472 U.S. 299, 105 S. Ct. 2622 (1985) (considering the legislative history of the Insider Trading Sanctions Act of 1984 in interpreting the relative culpability of tippers and tippees under Section 10(b)).

In 1984, Congress adopted the provisions of the Insider Trading Sanctions Act of 1984 (the "1984 Act"), which among other things provided the SEC with the ability to seek a new civil penalty of up to three times the amount of profit gained or loss avoided by a person who violates the federal securities laws by trading on the basis of material non-public information. *See* H.R. Rep. No. 355, 98th Cong., 2nd Sess. 1 (1983), *reprinted in* 1983 U.S.C.C.A.N. 2274. The House Report accompanying the legislation clearly established that Congress considered the misappropriation theory a valid part of the judicial framework available to combat illegal trading under Section 10(b). The Report stated:

> Since its creation the [SEC] has . . . appropriately used the antifraud provisions to remedy unlawful trading and tipping by persons in a variety of positions of trust and confidence who have illegally

> acquired or illegally used material nonpublic information."

Id. at 1.

Significantly, in enacting the 1984 Act, Congress refused to supply a definition of "insider trading," in part because it considered insider trading jurisprudence, including the misappropriation theory, "sufficiently well-developed at this time to provide adequate guidance." *Id.* at 13 n.20 (citing *United States v. Newman*, 664 F.2d 12 (2nd Cir. 1981), which applied the misappropriation theory) (footnote omitted).

Indeed, the House Report unequivocally stated that misappropriation of confidential information is exactly the type of "deception" sought to be prohibited by Section 10(b):

> In other areas of the law, deceitful misappropriation of confidential information by a fiduciary, whether described as theft, conversion, or breach of trust, has consistently been held to be unlawful. The Congress has not sanctioned a less rigorous code of conduct under the federal securities laws.

H.R. Rep. No. 355 at 5.

Congress again expressly endorsed the misappropriation theory as addressing the type of conduct proscribed by Section 10(b) when it considered and passed the Insider Trading and Enforcement Act of 1988 (the "1988 Act"). *See* H.R. Rep. No. 910, 100th Cong., 2d Sess. 10 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6047. In summarizing the parameters of insider trading restrictions as interpreted by the federal courts, Congress took special note of the misappropriation theory as developed by the Second Circuit:

> In cases where a trader did not have a duty to disclose material nonpublic information to the other party to the transaction, the SEC and the Department of Justice have pursued insider traders using an alternative theory: that individuals have a duty not to "misappropriate" information from their employers or otherwise in breach of a fiduciary or other relationship of trust and confidence, and commit securities fraud when they trade in possession of misappropriated information or tip others who trade. Under current case law, the SEC must establish that the person misusing the information has breached either a fiduciary duty to shareholders or some other duty not to misappropriate insider information. Within the court-developed parameters for insider trading, courts that have addressed the issue have also broadened the doctrine of insider trading to include trading and tipping by persons who misappropriate material nonpublic information from sources other than market participants. That was the theory underlying the case of *United States v. Carpenter*.

Id. at 10 (citations omitted). Although the split decision by this Court in the *Carpenter* case left the misappropriation theory "unresolved nationally," the House Committee believed that "this type of security fraud should be encompassed within Section 10(b) and Rule 10b-5." *Id.*

In considering the 1988 Act, Congress not only roundly endorsed the misappropriation theory as proscribing "deceptive" practices within the plain language of Section 10(b), but also

implicitly endorsed the theory as satisfying Section 10(b) and Rule 10b-5's requirements that the proscribed deceptive conduct be "in connection with" the purchase or sale of securities. In discussing the 1988 Act's express private right of action for contemporaneous traders injured by insider trading, the Committee report is explicit in stating that such rights extend to actions brought under the misappropriation theory.

> **In particular, the codification of a right of action for contemporaneous traders is specifically intended to overturn court cases which have precluded recovery for plaintiffs where the defendant's violation is premised upon the misappropriation theory.** *See e.g., Moss v. Morgan Stanley*, 719 F.2d 5 (2nd Cir. 1983). The Committee believes that this result is inconsistent with the remedial purposes of the Exchange Act, and that the misappropriation theory fulfills appropriate regulatory objectives in determining when communicating or trading while in possession of material nonpublic information is unlawful.

H.R. Rep. No. 910 at 26-7 (emphasis added).

By providing a private right of action for contemporaneous traders who pursue a Section 10(b) claim under the misappropriation theory, Congress made clear that the theory satisfies the plain language of Section 10(b) that requires that deceptive practices be "in connection with" the purchase or sale of securities. Unlike the *O'Hagan* and *Bryan* courts below, Congress has expressed its opinion that the deceptive practice need only be "in connection with" the wrongdoer's own purchase or sale of securities. This subsequent legislative history is as relevant to interpretation of Section 10(b) here at it has in

Bateman supra. The 1984 and 1988 Acts may be fairly read as rising to the level of a "ratification" of the "misappropriation theory," as Congress codified that theory in granting the SEC the right to seek new civil penalties for trading on the basis of misappropriated material, nonpublic information and providing a private right of action for contemporaneous traders injured by insider trading. *See Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367, 380-381, 89 S. Ct. 1794, 1801-02 (1969) (subsequent legislation declaring the intent of an earlier statute is entitled to great weight in statutory construction).

In fact, the Ninth Circuit, in *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990) specifically relied on the legislative history of the 1984 and 1988 Acts in holding that the misappropriation theory is compatible with the broad language of Section 10(b) and Rule 10b-5. Inexplicably, neither the *O'Hagan* decision below nor the Fourth Circuit's *Bryan* decision addressed the unequivocal Congressional support for the misappropriation theory expressed in the 1984 and 1988 Acts. Given Congress's clear acceptance of the misappropriation theory as effectuating the intent of Section 10(b) and Rule 10b-5, this Court should reverse the Eighth Circuit's vacation of O'Hagan's convictions under the securities laws based on the misappropriation theory.

CONCLUSION

Based on the foregoing argument and authority, this Court should reverse the Eighth Circuit's holding and reinstate the convictions against James O'Hagan based on the misappropriation theory, and clarify that theory as set forth above.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1996

UNITED STATES OF AMERICA,

Petitioner,

v.

JAMES HERMAN O'HAGAN,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

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38 pp

TABLE OF CONTENTS

PAGE

Consent of Parties 1

Interest of Amici 1

Summary of Argument 2

Argument 4

I. The Misappropriation Theory is Inconsistent with this Court's Prior Interpretation of the 1934 Act 4

A. The misappropriation theory is inconsistent with the language and purpose of Section 10(b) 4

B. Congress has taken no action since 1934 that should cause this Court to alter its interpretation of Section 10(b) 11

1. Congress's intent in 1984 and 1988 with respect to the misappropriation theory is ambiguous 11

2. This Court should not look to the intent of subsequent Congresses to interpret Section 10(b) because that section has not been reenacted or amended since 1934 14

PAGE

II. Because the Misappropriation Theory is Inconsistent with this Court's Prior Interpretation of the 1934 Act, Lower Courts Have Applied the Theory Inconsistently, Leading to an Intolerably Vague Standard for Criminal Liability 17

A. The case law under the misappropriation theory is vague 17

B. The misappropriation theory is intolerably vague as a standard for criminal liability 23

III. Defining the Scope of the Misappropriation Theory will be Problematic 24

IV. Congress Needs to Enact a Law Defining Illegal Trading On Material Nonpublic Information 28

Conclusion 30

TABLE OF AUTHORITIES

CASES — PAGE(S)

Carpenter v. United States, 484 U.S. 19 (1987) . . 2, 11

Central Bank v. First Interstate Bank, 114 S. Ct. 1439 (1994) 4, 6, 15, 16, 17

Chiarella v. United States, 445 U.S. 222 (1980) 2, 5, 6, 7, 9, 17, 18, 24

Commissioner v. Acker, 361 U.S. 87 (1959) 24

Consumer Product Safety Commission v. GTE Sylvania, Inc., 447 U.S. 102 17

DeLorean v. DeLorean, 211 N.J. Super. 432, 511 A.2d 1257 (N.J. Super. 1986) 27

Dirks v. SEC, 463 U.S. 646 (1983) 7

Grayned v. City of Rockford, 408 U.S. 104 (1972) 23

Harroff v. Harroff, 100 N.C. App. 686, 398 S.E.2d 340 (N.C. App. 1990) 27

Santa Fe Industries v. Green, 430 U.S. 462 (1977) 3, 9, 28

Lampf, Pleva, Lipkind, Prupis & Pettigrow v. Gilbertson et al., 501 U.S. 350 (1991) 27

Laventhall v. General Dynamics Corp., 704 F.2d 407 (8th Cir. 1983), *cert. denied*, 104 S. Ct. 150 (1983) 12

Marriage of Auble, 125 Or. App. 554, 866 P.2d 1239 (Or. App. 1994) 27

Marriage of Sokolowski, 232 Ill. App. 3d 535, 597 N.E.2d 675 (Ill. App. 1992) 27

Musick, Peeler & Garrett v. Employers Insurance of Wausau, 113 S. Ct. 2085 (1993) 15

Patterson v. McLean Credit Union, 491 U.S. 164 (1989) 16

Public Employees Retirement System v. Betts, 492 U.S. 158 (1989) 17

SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991) 25

SEC v. Materia, 745 F.2d 197 (2d Cir. 1984) 25

SEC v. Singer, 786 F. Supp. 1158 (S.D.N.Y. 1992) . 25

SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) . . 5

Screws v. United States, 325 U.S. 91 (1945) 23

United States v. Bryan, 58 F.3d 933 (4th Cir. 1995) . 8

United States v. Chestman, 947 F.2d 551 (2d Cir. 1991), ... 8, 22, 25, 27

United States v. Kozminski, 487 U.S. 931 (1988) . 23, 24

United States v. Reed, 601 F. Supp. 685 (S.D.N.Y.), *rev'd in part on other grounds*, 773 F.2d 477 (2d Cir. 1985) 8, 21

United States v. Thompson/Center Arms Co., 504 U.S. 505 (1992) 24

United States v. Willis, 737 F. Supp. 269 (S.D.N.Y. 1990) 8

United States v. Wiltberger, 18 U.S. 76 (1820) 24

Weinberger v. Rossi, 456 U.S. 25 (1982) 17

STATUTES PAGE(S)

Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, §2, 102 Stat. 4677 (1988) 15

Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264, 1265 11

Securities Exchange Act of 1934, 15 U.S.C. §78a, et seq. . . . . passim

RULES PAGE(S)

Rule 10b-5, 17 C.F.R. §240.10b-5 . . . . . passim

Rule 14e-3, 17 C.R.F. §240.14e-3 1

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American Law Institute FEDERAL SECURITIES CODE, section 1603, cmt. d (1980) 26

Elkan Abramawitz, *Insider Trading: Another Chance for Clarity*, N.Y.L.J., Nov. 5, 1996 19

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Edward Brodsky, *Insider Trading: The Misappropriation Theory,* N.Y.L.J., Nov. 13, 1996 18

Charles C. Cox & Kevin S. Fogarty, *Bases of*

Insider Trading Law, 49 Ohio St. L.J. 353, 366 (1988) 8

Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 Va. L. Rev. 1, 57 (1980) . . 4

Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 Ga. L. Rev. 179, 195 (1991) 10

Henry G. Manne, *Insider Trading and the Stock Market* (1966) 1

William H. Painter, *The Federal Securities Code and Corporate Disclosure* 235-50 (1979) 1

Restatement (Second) of Agency, §395 (1058) 25

Draft Restatement (Third) of the Law Governing Lawyers §111(1) 22

Consent of Parties

The consents of Petitioner and Respondent to the filing of this brief have been filed with the Clerk of the Court.

Interest of Amici

Amici are professors of securities regulation or counsel for clients who participate in the securities markets. Amici are interested in the predictable interpretation of the securities laws in accordance with the statutory text and purpose. Amici have not received any compensation with respect to this brief.[1]

Although some Commentators argue that trading by corporate insiders (hereinafter "insider trading") should be legal, amici find the arguments for prohibition of insider trading more compelling.[2] Congress, however, has not specified when it is also illegal for persons who are not corporate insiders, such as the Respondent in this case, to trade while in possession of material nonpublic information. For this reason, and recognizing that there are other civil

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[1] This brief was authored by the law professors listed on the front cover hereof, and was not authored by counsel for a party. No one other than amici has made any monetary contribution to the preparation of this brief. This brief addresses one of the issues before the Court in this case, the misappropriation theory. Amici take no position on the applicability of Rule 14e-3 or the mail fraud statute to this case.

[2] *Compare, e.g.*, Henry G. Manne, *Insider Trading and the Stock Market* (1966) (insider trading should be legalized) with William H. Painter, *The Federal Securities Code and Corporate Disclosure* 235-50 (1979) (insider trading undermines investor confidence and compensates insiders irrespective of risk or effort).

and criminal penalties available against such traders,[3] amici urge this Court to affirm the holding below that the misappropriation theory is not authorized by the Securities Exchange Act (the "1934 Act").

Summary of Argument

1. Section 10(b) proscribes "manipulative or deceptive" practices "in connection with the purchase or sale of any security." This Court has concluded that it is a deceptive practice for a corporate insider to trade on the basis of material nonpublic information without first disclosing the information, but that corporate "outsiders" have no similar duty to disclose. *Chiarella v. United States*, 445 U.S. 222, 227-28 (1980).

Respondent was not an insider of the corporation whose shares he traded. His use of information belonging to his employer's client may be described as "conversion" or "misappropriation," but does not implicate the investor protection concerns of this Court after *Chiarella*. Absent a "material misrepresentation or material failure to disclose," Respondent's use of information was not "deception" as that

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[3] The Brief *Amici Curiae* North American Securities Administrators Association, Inc., and Law Professors in Support of Petitioner (the "NASAA Brief") asserts that apart from any § 10(b) violations, the "federal mail and wire fraud statutes independently prohibit most misappropriation." *Id.* at 6, citing *Carpenter v. United States*, 484 U.S. 19 (1987). A lawyer could also be sued under state agency law for misappropriation of information entrusted to his law firm by a client, *see* note 23 *infra*, and could perhaps be disbarred for such conduct. *See* note 20 *infra*.

term is used in §10(b). *Santa Fe Indus. v. Green*, 430 U.S. 462, 474 (1977).

Even if this Court departs from its prior interpretation of §10(b) by choosing to equate misappropriation with deception, Respondent's misappropriation did not occur "in connection with" the purchase or sale of a security. If anyone was deceived by Respondent, it was his employer and the employer's clients, not a person who bought or sold securities at the time Respondent did. This straightforward reading of the statute is further bolstered by the context of the 1934 Act: Congress's objective was to protect the integrity of securities markets, not to provide a general remedy for thefts of information. Furthermore, Congress has taken no action since 1934 that should cause this Court to alter its interpretation of §10(b).

2. Because the misappropriation theory is inconsistent with this Court's prior interpretation of §10(b), the case law applying the theory has been contradictory, and in criminal cases impermissibly vague. Such a theory simply cannot stand up to the due process scrutiny that is ordinarily applied by this Court to criminal statutes.

3. If this Court chooses to adopt the misappropriation theory, this Court will have to define its parameters far more clearly than the appellate courts have done so far. In doing so, this Court will have to develop a federal common law of fiduciary duty, or condition §10(b) liability on breach of state fiduciary duty law. In either case, this Court's definition of the misappropriation theory will take it far afield from the distinction made in *Santa Fe* between deception and breach of fiduciary duty. *Santa Fe*, 430 U.S. at 474-77.

4. Instead, this Court should reject the misappropriation theory and allow Congress to change the statutory prohibition if it so desires. Congress could impose on all traders a general duty to disclose material nonpublic information, and then set forth specific exceptions. Congress could also create for certain persons a federal property right in information, much like that created by courts using the misappropriation theory. Alternatively, Congress could adhere to the approach it has adhered to since 1934 and leave §10(b) alone.

Argument

I. The Misappropriation Theory is Inconsistent with this Court's Prior Interpretation of the 1934 Act.

A. *The misappropriation theory is inconsistent with the language and purpose of Section 10(b).*

With respect to "the scope of conduct prohibited by §10(b), the text of the statute controls [the Court's] decision." *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1446 (1994). This Court has "refused to allow 10b-5 challenges to conduct not prohibited by the text of the statute." *Id.* Unfortunately, the text of §10(b) does not even mention insider trading, and Congress probably did not envision insider trading as coming within the proscriptions of §10(b).[4] The federal courts for almost thirty years,

[4] "The conventional wisdom is that Congress enacted section 9 [prohibiting manipulation of security prices] to deal with manipulation and expressed its concern with insiders' informational advantage by enacting section 16 [denying insiders short-swing profits]." Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 Va. L. Rev. 1, 56-57 (1980). *See also* Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 Wash & Lee L. Rev. 1189, 1229 (1995).

however, have held that trading by corporate insiders in possession of material nonpublic information is a "deceptive" device in violation of § 10(b) and Rule 10b-5.

Many courts and commentators before 1980 interpreted §10(b) and Rule 10b-5 not only to prohibit insider trading, but also to require *any* person in possession of material nonpublic information to disclose that information to the market or to abstain from trading (the "parity of information theory"). *See SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). This Court, however, substantially narrowed the scope of §10(b)'s prohibition in 1980 when an employee of a financial printer was charged with trading on information obtained from his employer. This Court had been urged by the Government to adopt the parity of information theory and impose a duty to "disclose or abstain" from trading, as had been established in *Texas Gulf Sulphur*, but this Court declined to infer such a duty from the statute. "When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak." *Chiarella*, 445 U.S. at 235. As this Court explained, *id.* at 232, such a duty could not:

> arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence.

Although this Court rejected the parity of information theory, this Court's holding in *Chiarella* at least focused on the same issue as the parity of information theory: the scope of Chiarella's duty to investors in the company whose shares he traded or to the company in which they had invested ("But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence *between parties to a transaction*." *Chiarella*, 445 U.S. at 230 (emphasis added)). It is true that Chiarella's breach of his duty to yet another party, his employer's customer (the acquiring corporation), was argued by the Government on appeal as an alternative basis on which to impose liability. *Id.* at 235. This basis for liability was endorsed by the Chief Justice in his dissenting opinion. *Id.* at 240. A theory based upon protection of Chiarella's employer or its customers, however, was not even argued by the Government to the jury. *Id.* at 236. The explanation for this omission presumably was not ineptitude, but logic: whether or not the 1934 Act imposed a general duty on all persons to disclose material nonpublic information before trading, the statute was not designed to condition a duty to disclose on a corporate outsider's relationship either with his employer or derivatively with his employer's customers.[5]

In 1983, this Court again focused on the duties that investors owe to each other:

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[5] In *Chiarella*, this Court held that §10(b) is not violated "unless the trader has an independent duty of *disclosure*." *Central Bank*, 114 S. Ct. at 1446 (emphasis added). This duty of "disclosure" is one that logically can only be owed to investors in the market, not to the source of nonpublic information (who presumably already knows the information and would want to keep it confidential).

> We were explicit in *Chiarella* in saying that there can be no duty to disclose where the person who has traded on inside information "was not [the corporation's] agent,. . . was not a fiduciary, [or] was not a person in whom the *sellers* [of the securities] had placed their trust and confidence." 445 U.S. at 232. Not to require such a fiduciary relationship, we recognized, would "depar[t] radically from the established doctrine that duty arises from a specific relationship *between two parties*" and would amount to "recognizing a general duty between all *participants in market transactions* to forgo actions based on material, nonpublic information." *Id.* at 232, 233.

Dirks v. SEC, 463 U.S. 646, 654-55 (1983) (emphasis added). A tippee is thus liable if he "knew the information was given to him in breach of a duty by a person having a special relationship *to the issuer* not to disclose the information...." *Id.* at 661 (emphasis added) (quoting *In re Investors Management Co.*, 44 S.E.C. 633 (1971)). The critical issue in *Dirks*, as in *Chiarella*, was whether the trader (or in *Dirks*, the trader's tipper) had a duty to investors or to the corporation in which those investors owned stock. *See Dirks*, 463 U.S. at 663, n. 23 ("a violation may be found only where there is 'intentional or willful conduct designed to deceive or defraud *investors* . . .'") (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. at 199) (emphasis supplied); *Chiarella*, 445 U.S. at 230 (a duty to disclose under §10(b) arises "from a relationship of trust and confidence *between parties to a transaction*") (emphasis supplied). However broad or narrow a trader's duty might be to the other investors with whom he trades, that duty lies at the heart of §10(b) and has little to do with the central focus of the misappropriation theory — whether the trader breached a

fiduciary duty to third parties who may not have bought or sold the security in question.

There is legitimate concern that insufficient protection is afforded to investors by §10(b) as interpreted by this Court in *Chiarella*, and thus the appeal of the misappropriation theory is understandable. There is, however, no evidence that §10(b) of the 1934 Act was ever intended to protect newspapers from their columnists, patients from their psychiatrists, spouses from each other, parents from their children, or state lotteries from their commissioners.[6] Until this Court's holding in *Chiarella*, there was thus little thought given to conditioning liability under § 10(b) on whether or not a trader or a trader's tipper breached a fiduciary duty to some third party having little or no connection with the trading transaction.[7]

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[6] *See, e.g., Carpenter*, 484 U.S. at 19 (newspaper columnist); *United States v. Willis*, 778 F. Supp. 269 (SDNY 1991) (psychiatrist); *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc) (spouse), *cert. denied*, 503 U.S. 1004 (1992); *United States v. Reed*, 601 F. Supp. 685 (SDNY) (son), *rev'd in part on other grounds*, 773 F.2d 477 (2d Cir. 1985); *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995) (lottery commissioner).

[7] Even former SEC Commissioner Charles Cox has acknowledged that the misappropriation theory can be seen as "merely a pretext for enforcing equal opportunity in information." Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 Ohio St. L. J. 353, 366 (1988). *See* Bainbridge, *supra* note 4, at 1198. In sentencing Respondent in the instant case, the trial court considered Respondent's duty to his law firm and client as secondary to the impact of his trading on investors. "By the way, and parenthetically, I reject your counsel's argument and his theory that this is not a typical insider trading case. Certainly Dorsey and Whitney were identified as the victims, but it is obvious when you look at where the dollars came from, and the dollars

Moreover, the misappropriation theory also contradicts this Court's holding in *Santa Fe* on three separate grounds: the theory does not require "deception" as defined in *Santa Fe;* misappropriation under the theory need not be "in connection with" the purchase or sale of a security; and breach of fiduciary duty lies at the heart of the claim.

First, this Court held in *Santa Fe* that there must be a "material misrepresentation or material failure to disclose," for conduct to be "deception" as that term is used in §10(b). *Santa Fe*, 430 U.S. at 474 (citations omitted) (emphasis added).[8] Under *Chiarella,* Respondent had no duty to disclose information, since this Court rejected the view that mere possession of material nonpublic information, without more, gives rise to a duty to disclose. *Chiarella*, 445 U.S. at 235. Respondent appropriated information belonging to his employer's client for Respondent's own use. This is no more a "deception" for purposes of §10(b), however, than is any other conversion of property (for example, if Respondent had

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certainly came, that the victims from a pecuniary standpoint, were those who thought they were putting their options into a fair market when you weren't playing fair." *United States v. James Herman O'Hagan*, Crim. No. 4-[illegible]219, Transcript of Sentencing at 28 (October 27, 1994). Respondent was found guilty of violating §10(b) under the misappropriation theory, but was sentenced to prison by a judge who, once the parameters of the misappropriation theory were met, viewed Respondent's actions under a theory much more akin to the parity of information theory rejected by this Court in *Chiarella*.

[8] As pointed out by the Fourth Circuit in *United States v. Bryan* 58 F.2d at 949 n. 16, the misappropriation theory puts the materiality requirement under section 10(b) entirely out of context. Although the misappropriated information may be important to the employer, materiality is judged from the prospective of an investor, making materiality irrelevant if the employer is not an investor.

used his telephone at work to call his broker long distance without reimbursing his employer). The misappropriation theory thus does not comport with this Court's holding that a claim of fiduciary breach in a complaint "states a cause of action under any part of rule 10b-5 only if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute." *Santa Fe*, 430 U.S. at 473-74.

Second, Respondent's alleged misappropriation furthermore was not "in connection with" the purchase or sale of a security.[9] The most natural reading of this statutory language covers manipulation of a securities market or attempts to deceive a participant in securities markets. Respondent's conduct fits neither category; if anyone was deceived, it was his employer and the employer's clients, not a person who purchased or sold securities when Respondent did. This straightforward reading of the "in connection with" requirement comports with Congress's purpose in enacting the statute, which was to protect the integrity of securities markets, not to create a property right to information.

Third, because a trader is liable if he was in a relationship of trust and confidence with a third party and is not liable if he had no such relationship, fiduciary duty, not manipulation or deception, lies at the core of liability.

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[9] *See* Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA.L.REV. 179, 195 (1991) ("The Court [in *Blue Chip Stamps*] restricted the class of actionable claims under 10b-5 to those in which the fraud resulted in the purchase or sale of stock to the victim...[T]his connection between the fraud and the securities transaction has been completely eviscerated in cases applying the misappropriation theory.").

"Bootstrapping" the argument by characterizing the breach of fiduciary duty as itself being manipulation or deception does not change the fundamental character of the inquiry and does not bring the misappropriation theory any closer to the definition of "deception" under §10(b) set forth by this Court in *Santa Fe*.[10]

The misappropriation theory thus has logical consequences that go far beyond the meaning of the statute. Indeed, in the only case in which the misappropriation theory was squarely presented to this Court, only four of eight justices, without stating why, supported affirmance of securities law convictions. *Carpenter v. United States*, 484 U.S. 19, 24 (1987).

B. Congress has taken no action since 1934 that should cause this Court to alter its interpretation of Section 10(b).

1. Congress's intent in 1984 and 1988 with respect to the misappropriation theory is ambiguous.

In 1984, Congress enacted the Insider Trading Sanctions Act of 1984 (the "1984 Act") which, among other things, made it illegal to trade options and other derivative securities in circumstances where it would be illegal to trade in the underlying security. Insider Trading Sanctions Act

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[10] Petitioner's Petition for Writ of Certiorari, at 11, states that "[a] person who misappropriates information in breach of a fiduciary duty necessarily commits deception." The same, however, could be said of any breach of fiduciary duty not accompanied by disclosure of the breach to the injured party. For further discussion applying *Santa Fe* to insider trading, *see* Bainbridge, *supra* note 4, at 1257-61.

of 1984, Pub. L. No. 98-376, 98 Stat. 1264, 1265 (codified in scattered sections of 15 U.S.C.). The loophole closed by this provision is obvious — a corporate insider or her tippee should not be allowed to circumvent §10(b) by trading in options instead of the underlying security. This provision shows that Congress was aware of the limited reach of §10(b), which some courts had held not to extend to trades with options dealers to whom an insider owes no fiduciary duty. *See Laventhall v. General Dynamics Corp.*, 704 F.2d 407, 411-12 (8th Cir. 1983), *cert. denied*, 464 U.S. 846 (1983). The 1984 Act also shows that Congress knew how to expand the reach of the 1934 Act insider trading prohibition when it wanted to.[11]

In the Insider Trading and Securities Fraud Enforcement Act of 1988, Congress enacted Section 20A of the 1934 Act providing a remedy for contemporaneous traders against "any person who violates any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information." Nowhere does the language of Section 20A expand the scope of prohibited conduct under the 1934 Act to include misappropriation of information for trading in the securities markets, despite the fact that Congress was aware

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[11] Amici in support of Petitioner instead interpret this amendment to have "generalized the misappropriation theory" under §10(b) because "corporations and their insiders do not owe fiduciary duties to those who own or trade options on corporate securities when those options are issued by others." NASAA Brief at 17. This interpretation reads far more into Congress's intent than is evident from the text of the statute, and indeed this amendment could just as well show that Congress was aware that §10(b) generally did not reach trading with persons to whom one owes no duty to disclose.

that this Court had apparently split 4-4 on the validity of the misappropriation theory in *Carpenter*. The first paragraph of Section 20A does not even mention "possession of *misappropriated* material, nonpublic information," the least a Congress eager to endorse the misappropriation theory might have done to show with which side of an evenly divided Supreme Court it agreed.

As Petitioner correctly points out, the legislative history indicates that Congress in 1988 sought to expand insider trading liability beyond the "classical theory" (extending the prohibition only to corporate insiders, corporate agents and their tippees), and that some members of Congress recognized the misappropriation theory as one means by which courts had accomplished that end. The House Committee on Energy and Commerce ("House Committee"), even in endorsing the misappropriation theory, nonetheless recognized this to be an unsettled area of the law: "The Court's opinion [in *Carpenter*] contained no discussion of the [misappropriation theory]. Thus, the misappropriation theory clearly remains valid in the Second Circuit . . . but is unresolved nationally." *Insider Trading and Securities Enforcement Act of 1988*, H.R. Rep. No. 910, 100th Cong., 2d Sess. 10 (1988). Although the Committee believed that "this type of security fraud should be encompassed within Section 10(b) and Rule 10b-5," *id.*, Congress did not act to include this or any other definition of illegal trading on the basis of material nonpublic information in the language of Section 10(b), despite the fact that some members of Congress recognized that a definition was needed. For example, Senator D'Amato, in introducing the Insider Trading Proscriptions Act of 1987, observed that:

> the present state of uncertainty about the law is simply not acceptable. The ambiguities about the law were vividly demonstrated in subcommittee hearings earlier where members of the securities industry and securities bar could not specify what conduct constituted insider trading and what conduct is permissible. I believe that an 'I know it when I see it standard' is totally unacceptable.

Statement of Alfonse D'Amato, Statements on Introduced Bills and Joint Resolutions, 100th Cong., 1st Sess., June 17, 1987, 133 *Cong. Rec.* S 8252. The one thing that is clear with respect to Congress's actions in 1988 is that Congress ultimately decided to leave §10(b) alone.

Finally, the remedy enacted in 1988 is unconnected with the misappropriation theory. It is contemporaneous traders, not third parties alleging "misappropriation" of their confidential information, who are entitled to sue under Section 20A. Disjuncture between the misappropriation theory and Congress's objective of protecting investors has thus caused a glaring incongruence between the remedy given to market participants in 1988 and the misappropriation theory's definition of the violation creating that remedy (a definition not only remarkable in its vagueness, but having little connection with the contemporaneous trader empowered to sue for the alleged harm).

2. *This Court should not look to the intent of subsequent Congresses to interpret Section 10(b) because that section has not been reenacted or amended since 1934.*

"When the text of §10(b) does not resolve a particular issue, we attempt to infer 'how the 1934 Congress would

have addressed the issue . . . .'" *Central Bank*, 114 S. Ct. at 1448, quoting *Musick, Peeler & Garrett v. Employers Insurance of Wausau*, 508 U.S. 286, 292 (1993). Both the Petitioner and the NASAA amici in support of Petitioner, however, instead focus on the intent of the 1984 and the 1988 Congresses, and in particular on the "findings" at the beginning of the 1988 legislation enacting section 20A of the 1934 Act.[12] Although these findings suggest that Congress endorsed an expanded vision of the §10(b) insider trading prohibition in 1988 (after Respondent traded), nowhere does the statutory language specify how expansive Congress believed the insider trading prohibition under §10(b) to be. Most important, nowhere does the statutory language enacted by Congress in 1984 or 1988 purport to amend §10(b). Congress knows how to amend a statute, and also knows that expressing its approval of administrative enforcement actions under the prior statute in "findings" at the beginning of a new statute simply does not do the trick.

Two doctrines — the "reenactment doctrine" and the even more speculative "acquiescence doctrine" — might still make the work of the Congresses of 1984 and 1988 relevant to interpreting this statute enacted in 1934. Both of these doctrines, however, were discussed extensively in *Central Bank's* interpretation of §10(b) and were disregarded. With respect to the reenactment doctrine, this Court observed:

> "When Congress reenacts statutory language that has been given a consistent judicial construction,

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[12] Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, §2, 102 Stat. 4677 (1988) (appended to 15 U.S.C. §78u-1 (1994)), quoted in NASAA Brief at 20-21.

> we often adhere to that construction in interpreting the reenacted statutory language. [citations omitted] Congress has not reenacted the language of §10(b) since 1934, however, so we need not determine whether the other conditions for applying the reenactment doctrine are present. Cf. *Fogerty v. Fantasy, Inc.*, [114 S.Ct. 1023, 1030-1033] (1994).

Central Bank, 114 S.Ct. at 1452.[13] Neither can the misappropriation theory garner much further support from applying the "acquiescence doctrine" to the 1984 and 1988 amendments to the 1934 Act. The respondents in *Central Bank* argued that "Congress has amended the securities laws on various occasions since [courts began to adopt the interpretation that respondent's favored, and] from that, respondents infer that these Congresses, by silence, have acquiesced in the judicial interpretation of §10(b)." *Id.* at 1452. This Court rejected that argument, noting that this Court had reserved the issue of aiding and abetting on two previous occasions. This Court went on to observe that such an "acquiescence doctrine" has its limitations because "Congressional inaction cannot amend a duly enacted statute." *Id.*. at 1453, quoting *Patterson v. McLean Credit Union*, 491 U.S. 164, 175 n. 1 (1989).

Furthermore, in *Central Bank*, this Court specifically rejected reliance on references to aiding and abetting liability in the 1983 and 1988 committee reports and reiterated that

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13 "At least insofar as the re-enactment doctrine applies to cases arising under Rule 10b-5, however, *Central Bank* places it in serious jeopardy." Bainbridge, *supra* note 4, at 1205.

"[w]e have observed on more than one occasion that the interpretation given by one Congress (or a committee or Member thereof) to an earlier statute, is of little assistance in discerning the meaning of that statute." *Id.* at 1452, quoting *Public Employees Retirement System v. Betts*, 492 U.S. 158, 168 (1989); and citing *Weinberger v. Rossi*, 456 U.S. 25, 35 (1982); *Consumer Product Safety Comm'n v. GTE Sylvania, Inc.*, 447 U.S. 102, 118 n. 13 (1980).

This Court thus declined to apply either the reenactment doctrine or the acquiescence doctrine to §10(b) and concluded its discussion by stating in no uncertain terms that "[w]e find our role limited when the issue is the scope of conduct prohibited by the statute. [citation omitted]. That issue is our concern here, and we adhere to the statutory text in resolving it." *Central Bank*, 114 S.Ct. at 1453. This Court cannot, consistent with *Central Bank*, give substantial weight to the intent of the Congresses of 1984 and 1988 concerning § 10(b) of the 1934 Act.

II. Because the Misappropriation Theory is Inconsistent with this Court's Prior Interpretation of the 1934 Act, Lower Courts Have Applied the Theory Inconsistently, Leading to an Intolerably Vague Standard for Criminal Liability

A. The case law under the misappropriation theory is vague.

In *Chiarella*, this Court rejected the parity of information theory under which "the use by anyone of material information not generally available is fraudulent because such information gives buyers or sellers an unfair advantage over less informed buyers and sellers." *Chiarella*, 445 U.S. at 231. This theory imposed on all persons in possession of

material nonpublic information a duty to disclose or abstain from trading. The duty was presumed to extend from traders to other market participants and would not have conditioned liability on breach of a fiduciary duty to some third party who may or may not have been a market participant.

The parity of information theory was rejected by this Court in *Chiarella* on the grounds that neither the language of §10(b) nor the legislative history evidenced a Congressional intent to create such a rule. *Id.* at 233. Moreover, this Court expressed concern that such a holding "would raise questions whether criminal or civil defendants would be given fair notice that they have engaged in illegal activity." *Id.* at 235 n.20 (citing *Grayned v. City of Rockford*, 408 U.S. 104, 108-09 (1972)).

Since *Chiarella*, various interpretations of the misappropriation theory have been articulated by district and appellate courts, each reaching a narrower range of conduct than the parity of information theory. However, this more "targeted" approach to insider trading liability has a price that may be inevitable when legal proscriptions are enacted by courts rather than by Congress: each court interpreting the theory has envisioned a target of different size and shape, making the misappropriation theory intolerably vague. The possibility of fines, penalties, lost careers and even jail terms rests on an uncertain articulation of which parties have a duty to refrain from trading while in possession of material nonpublic information.[14] This vagueness is compounded by

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[14] *See* Edward Brodsky, *Insider Trading: The Misappropriation Theory*, N.Y.L.J., Nov. 13, 1996 (arguing that the case-by-case

the fact that the target -- or rather moving target -- fixed in the sights of courts using the misappropriation theory is breach of fiduciary duty owed to an entrustor of confidential information, a concern having little to do with manipulative or deceptive conduct defrauding participants in the securities markets. Rather than urge Congress to respond to *Chiarella* by amending the 1934 Act to adopt an investor protection - based philosophy such as the parity of information theory, the Commission has urged courts, by expanding upon Chief Justice Burger's dissenting opinion in *Chiarella*, to take uncoordinated aim at a new doctrinal target having little relation to the purposes for which the statute was enacted.

Examples (both real and hypothetical) of the inconsistency generated by the misappropriation theory are plentiful:

1) A psychiatrist buys or sells shares of BankAmerica Corporation after learning from a patient, the wife of the president of American Express, that her husband is seeking to become CEO of BankAmerica; *or* 2) the same facts as above, but the wife passes the inside information to her hairdresser, rather than her psychiatrist.[15]

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evolution of the misappropriation theory has led to confusion in an area where, given the possibility of criminal sanctions, certainty is needed); Elkan Abramawitz, *Insider Trading: Another Chance for Clarity*, N.Y.L.J., Nov. 5, 1996 (noting that the current unpredictability regarding the scope of the misappropriation theory "creates a fundamental unfairness to defendants who lack adequate notice of the legality and consequences of their actions").

[15] *See United States v. Willis*, 778 F. Supp. 269 (S.D.N.Y. 1991) in which the court sustained the psychiatrist's conviction for insider trading based on the breach of the fiduciary duty owed by a psychiatrist to a patient. The hairdresser example was taken from John R. Beeson, Com-

3) A corporate CFO confesses to a priest that she has been manipulating the books of her company to increase earnings. The priest absolves the penitent of her sins and calls his broker to place a sell order; *or* 4) the same facts as above, but the CFO confesses her fraudulent conduct to a fellow parishioner from whom she seeks advice on whether to turn herself in. The fellow parishioner promises divine forgiveness and calls his broker.[16]

5) The author of the "Heard on the Street" column in the *Wall Street Journal* trades on information learned in connection with research conducted for the column, in violation of a policy of his employer, Dow Jones, Inc., prohibiting such trading; *or* 6) the same facts as above, but Dow Jones, Inc. authorizes the author of the "Heard on the Street" column to trade on recommendations that he intends to make the next day.[17]

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ment, *Rounding the Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory*, 144 U. Pa. L. Rev. 1077, 1137 (1996). Presumably no insider trading liability would attach to the hairdresser's trades, as the relationship between client and hairdresser does not give rise to a fiduciary duty under state law.

[16] Following the logic of *Willis*, the priest is arguably guilty of insider trading under the misappropriation theory based on a breach of the relationship of trust and confidence owed by a priest to a parishioner. Application of the misappropriation theory to the second situation, however, might require a court to delve into whether the person to whom the confession was made had a duty under applicable church doctrine not to disclose or use the information.

[17] The first example sets forth the facts of *Carpenter v. United States*, 484 U.S. 19 (1987). In the second example, the trades are presumably legal.

7) Father, a board member of ABC Corporation, often discloses confidential information about ABC Corporation to his son. Relying on such confidential information, the son purchases ABC call options; *or* 8) Wife, whose family founded and still controls ABC Corporation, tells her husband that the family has agreed to sell the business to an acquiror at a substantial premium over current market value. The next day, Husband instructs his broker to purchase shares of ABC Corporation.[18]

The differing results in the above examples highlight a serious shortcoming of the misappropriation theory: insider trading liability turns not on effects on the marketplace or on potential damage to selling or purchasing shareholders, but rather on a duty owed to the *source* of the information, regardless of whether that source is a buyer or seller of securities or even a market participant at all. Even worse, because the duty to that source arises from a fiduciary or "similar relationship of trust and confidence," the scope of that duty may be defined by state law, by private agreement (as in the *Wall Street Journal* case) or by the inherent nature of some other relationship (as in the parishioner, psychiatrist

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[18] The facts of the father/son example are based on *United States v. Reed*, 601 F.Supp. 685 (S.D.N.Y.), *rev'd. on other grounds*, 773 F.2d 477 (2d Cir. 1985), in which an allegation that the son breached a fiduciary duty to his father by trading on confidential information withstood a motion to dismiss. The court noted that the father and son frequently discussed business issues, thus giving rise to the equivalent of a fiduciary relationship. *Id.* at 690 n.6. The husband/wife example is derived from the facts of *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc), in which the court held that no fiduciary or similar relationship of trust and confidence existed between the husband and wife so as to give rise under the misappropriation theory to liability of the husband's stockbroker as a "tippee."

and family relationship examples). This is problematic because the scope of fiduciary duties outside the traditional corporate insider context is far from clear, particularly when courts are asked to consider which relationships, although not fiduciary in the traditional sense, nonetheless constitute a "similar relationship of trust and confidence."[19] Indeed, this lack of clarity raises concerns of constitutional proportion in the criminal context. *Chestman*, 947 F.2d at 570 ("Useful as such an elastic and expedient definition of confidential relations, i.e., relations of trust and confidence, may be in the civil context, it has no place in the criminal law").

The attorney/client relationship provides a good illustration of the ambiguity which surrounds the scope of fiduciary duties outside the traditional corporate insider context. Respondent's conduct does not unequivocally run afoul of the ALI's position that trading on confidential client information is prohibited when "there is a substantial likelihood that doing so will adversely affect a material interest of the client or if the client has directed that the lawyer not use [the information]." Draft Restatement (Third) of the Law Governing Lawyers §111(1).[20]

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[19] *See, e.g. Chestman*, 947 F.2d at 567 ("[A] fraud-on-the-source theory of liability extends the focus of Rule 10b-5 beyond the confined sphere of fiduciary/shareholder relations to fiduciary breaches of any sort, a particularly broad expansion of 10b-5 liability if the add-on, a 'similar relationship of trust and confidence,' is construed liberally").

[20] Trading by the acquiror's attorney in stock of a target, particularly in large quantities, could harm the client tender offeror by putting upward pressure on the price of the target company stock. On the other hand, the lawyer's purchases could help the client by putting more stock in friendly hands. *See* Stephen M. Bainbridge, *Insider Trading Under the Restatement of the Law Governing Lawyers*, 19 J.CORP.L. 1 (1993). Although Professor Bainbridge has urged the ALI to adopt a more definitive ban on trading by a lawyer on confidential client information, the drafters of the Restatement so far have not done so.

Adoption of the misappropriation theory will thus require the federal courts to embroil themselves not only in this debate over the fiduciary duties of lawyers to their clients, but in similar debates over the fiduciary duties of accountants, appraisers, and investment bankers to their clients; doctors to their patients; taxi and limousine drivers to their passengers; newspaper columnists to their employers and their readers; professors to their students who work for law firms; priests, ministers and rabbis to their parishioners; and so on. In each case, a federal court will have to analyze the particular relationship to determine whether a "relationship of trust and confidence" existed sufficient to send one of the parties to jail for misappropriation of information entrusted to him by the other.

B. *The misappropriation theory is intolerably vague as a standard for criminal liability.*

The common-law development of criminal standards through the misappropriation theory furthermore implicates due process considerations previously articulated by this Court. This Court has repeatedly recognized, for example, that a statute prescribing criminal punishment must provide a definite standard of guilt. *See, e.g., Screws v. United States*, 325 U.S. 91 (1945); *United States v. Kozminski*, 487 U.S. 931 (1988); *Grayned v. City of Rockford*, 408 U.S. 104

(1972); *Chiarella*, 445 U.S. at 235.[21] As pointed out above, the misappropriation theory is extraordinarily vague and would probably be unconstitutionally vague as applied to at least some criminal defendants.

III. Defining the Scope of the Misappropriation Theory Will be Problematic.

If, irrespective of the arguments developed above, this Court finds that the language of § 10(b) encompasses the misappropriation theory, this Court will need to define the

[21] In *United States v. Wiltberger*, 18 U.S. 76 (1820), Chief Justice Marshall articulated three principles to guide courts in the judicial construction of criminal statutes. First, he observed that the legislature, not the judiciary, should define crimes and establish punishments for their violation. *Id.* at 95 For example, in *United States v. Kozminski*, 487 U.S. 931 (1988), this Court noted that "[i]t is one thing to recognize that some degree of uncertainty exists whenever judges and juries are called upon to apply substantive standards established by Congress; it would be quite another thing to tolerate the arbitrariness and unfairness of a legal system in which judges would develop the standards for imposing criminal punishment on a case-by-case basis." *Id.* at 951. Justice Marshall's second principle, the "rule of lenity," dictates that ambiguity concerning the scope of a criminal statute be resolved in favor of the defendant. *Wiltberger*, 18 U.S. at 96. *See also United States v. Granderson*, 114 S.Ct. 1259, 1267 (1994) ("where text, structure, and history fail to establish that the Government's position is unambiguously correct -- we apply the rule of lenity and resolve the ambiguity in [defendant's] favor"); *United States v. Thompson/Center Arms Co.*, 504 U.S. 505, 517-18 (1992) (invoking the rule of lenity to resolve an ambiguity in a tax statute). Chief Justice Marshall's third canon of judicial construction of criminal statutes holds that criminal statutes must be strictly construed. *Wiltberger*, 18 U.S. at 95-96; *Commissioner v. Acker*, 361 U.S. 87, 91 (1959). "[T]o determine that a case is within the intention of the statute, it's language must authorize us to say so." *Wiltberger*, 18 U.S. at 95-96.

scope of the underlying relationship of trust and confidence giving rise to a duty to disclose material nonpublic information. There are two approaches this Court could take: either develop a federal common law of fiduciary duty, or condition liability on the defendant's breach of state fiduciary duty law.[22] *See* Bainbridge, *supra* note 4 at 1206.

Developing a federal common law of fiduciary duty would be the simplest approach to defining the necessary confidential relationship. A number of courts adopting the misappropriation theory have relied upon the provisions of the Restatement (Second) of Agency ("Restatement") concerning a fiduciary's use of confidential information.[23] This Court may find, however, that this definition is not complete for purposes of federal securities law, as the Restatement is focused on potential competition with or injury to the principal, not on potential injuries to investors

[22] Courts adopting the misappropriation theory seem to be creating a federal common-law of confidential relationships without explicitly addressing the choice-of-law issue. *See, e.g., Chestman*, 947 F.2d at 570 (marriage, without more, is not a fiduciary relationship; no discussion of choice of law); *Willis*, 778 F. Supp. at 209 (a psychiatrist-patient relationship is a fiduciary relationship; no discussion of choice of law); *SEC v. Singer*, 786 F. Supp. 1158, 1169-70 (S.D.N.Y. 1992) (holding that an attorney is a fiduciary to his client without relying on state regulation of lawyers or federal common law).

[23] *See, e.g., Chestman*, 947 F.2d at 569; *SEC v. Cherif*, 933 F.2d 403, 411 (7th Cir. 1991), *cert. denied*, 502 U.S. 1071 (1992); *SEC v. Materia*, 745 F.2d 197, 202 n.4 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985). Section 395 of the Restatement (Second) of Agency prohibits agents from using or communicating confidential information of the principal "in competition with or to the injury of the principal," even if such information does not relate to the transaction in which he is then employed. RESTATEMENT (SECOND) of AGENCY, § 395 (1958).

with whom the agent trades. Thus, this concept would presumably reach purchases of a would-be tender offeror's target stock by a lawyer or accountant of the tender offeror, since the principal (tender offeror) could be injured by such an action. It might not reach a *Chiarella*-type situation, however, depending on how broadly the concept of "injuring the principal" is construed, and indeed on who the principal is understood to be, nor would it necessarily reach a judge's law clerk who traded on information contained in an opinion that had not yet been issued, or a Federal Reserve Bank employee who trades with knowledge of an imminent change in the margin rate.[24] Thus, even in relying on the Restatement, this Court would still need to grapple with key definitional issues, including how broadly to construe the concept of "injuring the principal," and what connection the investment transaction ought to have to the fiduciary relationship.

Instead of developing a federal common law of fiduciary duty, this Court could incorporate state law fiduciary duty concepts into its rule of decision. Under that approach, the content of the federal insider trading prohibition would vary depending on which state's law controls. *See* Bainbridge, *supra* note 4, at 1206. Incorporating state law fiduciary duty concepts as the lynchpin of a federal securities claim of insider trading thus potentially leads to different results on

[24] *See* American Law Institute, FEDERAL SECURITIES CODE, § 1603, cmt. d (1980) (suggesting a category of "quasi-insider" be developed to bring these types of traders within the ambit of prohibited trading on material nonpublic information).

similar facts in different states.[25] While this may be an acceptable outcome on principles of federalism where a state-law question is concerned, it is much less acceptable in interpreting the federal securities statutes, where a uniform interpretation best effectuates federal policies of predictability, judicial economy and investor protection. *Cf. Lampf, Pleva, Lipkind, Prupis & Pettigrow v. Gilbertson et al.*, 501 U.S. 350, 357 (1991).

Moreover, under either approach the misappropriation theory would take §10(b) jurisprudence precisely where this Court said it should not go: into the terrain of fiduciary duty law. *See Santa Fe*, 430 U.S. at 472. By conditioning breach of §10(b) on an underlying breach of a fiduciary duty, this jurisprudence requires the federal courts to decide

[25] One need only look at the different states' views on the fiduciary character of a marriage to understand how fractured the securities law would become if this Court determined that incorporation of state law was the proper approach. While the Second Circuit held that marriage *per se* does not give rise to a fiduciary relationship in New York, *Chestman*, 947 F.2d at 571, other courts disagree, but also cannot agree among themselves as to when the fiduciary relationship begins and ends. *See DeLorean v. DeLorean*, 511 A.2d 1257 (N.J. Super. 1986) (married persons owe each other fiduciary duties); *In re: Marriage of Sokolowski*, 597 N.E.2d 675 (Ill. App. 1992) (confidential relationship begins at engagement); *Harroff v. Harroff*, 398 S.E.2d 340 (N.C. App. 1990) (fiduciary duties still owed during negotiation of a separation agreement). *In re: Marriage of Auble*, 866 P.2d 1239 (Or. App. 1994) (no such duties owed by persons ending their marriage). Indeed, given the variations among state court decisions on this issue, liability for trading on material non-public information would vary depending on whether one was unofficially engaged, officially engaged, married, happily married, negotiating a separation agreement, separated or divorced, and may even depend on whether confidential information was disclosed at a couple's New York apartment or New Jersey country home.

when a fiduciary duty exists and when that duty has been breached. Yet this Court in *Santa Fe* eschewed that role for the federal courts applying federal securities law, both because the language of §10(b) and Rule 10b-5 does not permit encompassing breaches of fiduciary duty separate from deceptive conduct in a securities transaction, *id.*, and because of federalism concerns. *Id.* at 478. Those same rationales ought to be determinative here.

IV. Congress Needs to Enact a Law Defining Illegal Trading On Material Nonpublic Information.

Ultimately, it is up to Congress to define the parameters of illegal trading, and the necessary connection between a trading transaction and any third-party fiduciary relationship. Indeed, over the last ten years, as the Commission has begun more vigorously to enforce insider trading prohibitions, including by criminal referral, and as the penalties for such trading have been enhanced, many people have called on Congress to specify when trading on material nonpublic information is illegal, so far without success.

In spite of its reluctance to act, Congress is the best institution to make these determinations, and there are several approaches it could take. Congress could establish a *pre-Chiarella* parity-of-information approach, even for outsiders, and then carve out exceptions for securities analysts, and perhaps others in possession of material nonpublic information. Congress could develop a statutory definition of the proscribed conduct based on a theory of property rights in information, and clearly define the relationship between the property rights in information and the trading transaction necessary to give rise to liability. In addition, Congress could bifurcate criminal liability from

civil liability and SEC enforcement actions, in order to allow broader liability in the civil context and yet define clear, very specific standards for the imposition of criminal sanctions. Finally, Congress could adopt the insider trading provisions of the Federal Securities Code, developed with great care over ten years by the American Law Institute under the guidance of Professor Louis Loss.[26] Absent such a determination by Congress, though, this Court ought not itself legislate the proper policy approach to trading on material nonpublic information.

We condemn the alleged conduct at the core of this case — a lawyer's use of confidential client information to trade in the stock market. Trading while in possession of material nonpublic information can "cheat" honest market participants out of an even playing field, just as cheating on examinations cheats honest students out of a fair chance to demonstrate their knowledge and ability. However, those of us who are law professors recognize that it would be perilous to seek the expulsion of a student for conduct not coming squarely within the proscriptions of a school's honor code. Indeed, we recognize that the absence of a clearly defined honor code may encourage cheating. Similarly, Congress needs to do what the courts and the Commission at this point cannot — assure the integrity of our securities markets by specifying when it is illegal to trade while in possession of material nonpublic information or by giving the Commission the authority to do the same.

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[26] *See* American Law Institute, FEDERAL SECURITIES CODE, § § 1602, 1603 (1980).

The misappropriation theory is appealing precisely because it comports with our collective sense of moral approbation of people breaching a position of trust for their personal, financial advantage. What it does not do however, is comport with the fundamental policy concerns of Congress in enacting the 1934 Act: investor protection and the integrity of the market. An investor who has paid too much for stock or sold it for too little in a transaction with a person in possession of material nonpublic information suffers loss irrespective of whether the counterparty breached a fiduciary duty to a third party. Conditioning liability on the counterparty's relationship with the third party introduces state fiduciary duty law into the heart of federal insider trading regulation. If Congress believes that the 1934 Act as interpreted by this Court in *Chiarella* does not adequately protect such investors, the Act should be amended.

Conclusion

For the foregoing reasons, amici respectfully request this Court to affirm the holding below.

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In the Supreme Court of the United States

OCTOBER TERM, 1996

UNITED STATES OF AMERICA,
Petitioner,

v.

JAMES HERMAN O'HAGAN,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF NATIONAL ASSOCIATION OF CRIMINAL DEFENSE LAWYERS AS AMICUS CURIAE IN SUPPORT OF RESPONDENT

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23 pp

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TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES ii

INTEREST OF *AMICUS CURIAE* 2

SUMMARY OF ARGUMENT 3

ARGUMENT 4

I. THIS COURT SHOULD REJECT THE GOVERNMENT'S INTERPRETATION OF SECTION 10(b) BECAUSE CONGRESS NEVER ENACTED THE MISAPPROPRIATION THEORY AS A CRIME. 4

II. THERE IS NO EVIDENCE THAT CONGRESS INTENDED THAT SECTION 10(b) CRIMINALIZE ALL TRADING ENABLED BY A BREACH OF TRUST OR CONFIDENCE. .. 10

A. Congress Was Aware Of The Problem Of Trading On Misappropriated Information, And Chose Only To Prohibit Some Forms Of That Conduct 10

B. Congress' Actions Since 1934 Have Not Altered The Scope Of Section 10(b) 14

CONCLUSION 17

TABLE OF AUTHORITIES

CASES — Page

Aaron v. Securities and Exchange Commission, 446 U.S. 680 (1980) 4, 15
Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) 4-5
Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994) 5, 10, 15
Chiarella v. United States, 445 U.S. 222 (1980) 5, 14
Consumer Product Safety Commission v. GTE Sylvania, Inc., 447 U.S. 102 (1980) 15
Crandon v. United States, 494 U.S. 152 (1990) 6
Dirks v. Securities and Exchange Commission, 463 U.S. 646 (1983) 5, 13, 14
Dowling v. United States, 473 U.S. 207 (1985) 5
Dunn v. Commodity Futures Trading Commission, 117 S. Ct. 913 (1997) 9
Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) 4, 12
Fasulo v. United States, 272 U.S. 620 (1926) 6
Foremost-McKesson, Inc. v. Provident Securities Co., 423 U.S. 232 (1976) 12
In the Matter of Cady, Roberts & Co., 40 S.E.C. 907 (1961) 13, 14
Jerome v. United States, 318 U.S. 101 (1943) 5
Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973) 12
Liparoda v. United States, 471 U.S. 419 (1985) 5
McNally v. United States, 483 U.S. 350 (1987) 15
Patterson v. McLean Credit Union, 491 U.S. 164 (1989) 15
Public Employees Retirement System v. Betts, 492 U.S. 158 (1989) 15
Rewis v. United States, 401 U.S. 808 (1971) 6
Rivers v. Roadway Express, 511 U.S. 298 (1994) 15
Securities and Exchange Commission v. Cherif, 933 F.2d 403 (7th Cir. 1991) 4, 7
Securities and Exchange Commission v. Clark, 915 F.2d 439 (9th Cir. 1990) 4, 7

TABLE OF AUTHORITIES -- Continued

Page

Securities and Exchange Commission v. Cooper, 1995 WL 739046 (S.E.C. Release No. 14754) (C.D. Cal. 1995) 7
Securities and Exchange Commission v. Lenfest, 949 F. Supp. 341 (E.D. Pa. 1996) 7
Securities and Exchange Commission v. Maio, 51 F.3d 623 (7th Cir. 1995) 7
Securities and Exchange Commission v. Materia, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985) 4, 7
Securities and Exchange Commission v. Sheinberg, 1992 WL 372190 (S.E.C. Release No. 13465) (C.D. Cal. 1992) 7
TSC Industries v. Northway, Inc., 426 U.S. 438 (1976) 4
United States v. Bryan, 58 F.3d 933 (4th Cir. 1995) 5
United States v. Chestman, 947 F.2d 551 (2d. Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992) 7
United States v. Granderson, 511 U.S. 39 (1994) 6
United States v. Mandel, 672 F. Supp. 864 (D. Md. 1987), *aff'd*, 862 F.2d 1067 (4th Cir. 1988) 5
United States v. Pardee, 368 F.2d 368 (4th Cir. 1966) 5
United States v. Reed, 601 F. Supp. 685 (S.D.N.Y.), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985) 7
United States v. Willis, 737 F. Supp. 269 (S.D.N.Y. 1990) 7
United States v. Wiltberger, 18 U.S. (5 Wheat.) 76 (1820) 5
Viereck v. United States, 318 U.S. 236 (1943) 5
Weinberger v. Rossi, 456 U.S. 25 (1982) 15
Williams v. United States, 458 U.S. 279 (1982) 9

STATUTES

Securities Exchange Act of 1934,
Section 10(b), 15 U.S.C. § 78j(b) ..... *passim*
Section 16(a), 15 U.S.C. § 78p(a) 11
Section 16(b), 15 U.S.C. § 78p(b) 12
Section 16(c), 15 U.S.C. § 78p(c) 11
Section 20A, 15 U.S.C. § 78t-1(e) 15
Section 32(a), 15 U.S.C. § 78ff(a) 4

TABLE OF AUTHORITIES -- Continued

Page

RULES AND REGULATIONS

17 C.F.R. § 240.10b-5 ..... 4, 12, 13

LEGISLATIVE MATERIALS

S. Rep. No. 73-792 (1934) 11
H.R. Rep. No. 73-1383 (1934) 11
S. Rep. No. 73-1455 (1934) 11
H.R. Rep. No. 100-910 (1988) 16
S. 1380, 100th Cong. (1987) 9
Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong. (1934) 11
The Insider Trading Sanctions Act of 1983: Hearings on H.R. 559 Before the Subcom. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 98th Cong. (1984) 8
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BOOKS, TREATISES, AND ARTICLES

Donald C. Cook & Myer Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 395 (1953) .. 12
Donald C. Cook & Myer Feldman, *Insider Trading Under Securities Exchange Act*, 66 HARV. L. REV. 612 (1953) .. 12

TABLE OF AUTHORITIES -- Continued

Page

Milton V. Freeman, *Foreword to Happy Birthday Rule 10b-5: 50 Years of Antifraud Regulation Colloquium*, 61 FORDHAM L. REV. S3 (1993) 5
Conference on the Codification of the Securities Laws, 22 BUS. LAW. 793 (1967) 12-13
THE FEDERALIST NO. 78 (Hamilton) (Jacob E. Cooke ed. 1961) 10

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BRIEF OF NATIONAL ASSOCIATION
OF CRIMINAL DEFENSE LAWYERS
AS AMICUS CURIAE IN SUPPORT OF RESPONDENT

This *amicus curiae* brief is submitted in support of the Respondent, James O'Hagan. By letters filed with the Clerk of the Court, Petitioner and Respondent have consented to the filing of this brief.

INTEREST OF *AMICUS CURIAE*

The National Association of Criminal Defense Lawyers ("NACDL") is a nonprofit corporation with membership of more than 9,000 attorneys and 28,000 affiliate members in all fifty states. The American Bar Association recognizes the NACDL as an affiliate organization and awards it full representation in its House of Delegates.

The NACDL was founded in 1958 to promote study and research in the field of criminal law; to disseminate and advance knowledge of the law in the area of criminal practice; and to encourage the integrity, independence, and expertise of defense lawyers in criminal cases. Among the NACDL's objectives is to ensure the proper administration of justice and to ensure that criminal statutes are construed and applied in accordance with due process.

The NACDL files this *amicus curiae* brief to urge the Court to reject the so-called "misappropriation theory" of insider trading pursuant to the federal securities laws.[1/] One of the fundamental tenets of our Constitution is that the federal government may not impose criminal punishment unless Congress has acted clearly and decisively to declare the conduct to be illegal. Congress has not taken any such action with respect to the misappropriation theory. That theory is entirely a creation of the Securities and Exchange Commission and the Judiciary, and as such cannot constitutionally serve as a basis for a criminal conviction.

1/ Mr. Mathews and Wilmer, Cutler & Pickering formerly represented Mr. O'Hagan in connection with the Securities & Exchange Commission's investigation of the events at issue in this case. They have not represented Mr. O'Hagan in any state or federal administrative, civil, or criminal litigation since that time, and do not represent him in this proceeding.

SUMMARY OF ARGUMENT

Respondent James O'Hagan, formerly an attorney in Minnesota, stole client funds and attempted to cover up that theft using the proceeds of securities trading based on information misappropriated from his law firm and its client. For these actions, Mr. O'Hagan was convicted on eight counts of theft by the State of Minnesota. He served thirty months in prison and was disbarred by the Minnesota State Supreme Court. Clearly, Mr. O'Hagan has been punished for his misbehavior, and this case does not call upon the Court to exonerate him.

The question raised by the Government's appeal is whether, in addition to that punishment, Respondent can be sent to prison for violating a judicially-constructed "theory" that has never been enacted by Congress. A fundamental tenet of the Constitution is that only Congress may legislate federal crimes. It has not done so with respect to the misappropriation of material nonpublic information by outsiders. Because Congress did not and has not acted, the Securities and Exchange Commission ("S.E.C.") and the courts have crafted a variety of standards of liability, justified by clearly important policy considerations. Regardless of the merits of these justifications, creating criminal liability is an activity solely within the province of the Congress.

Congress has been aware of the problem of trading on misappropriated information since 1934. Despite this, the legislature clearly intended only to prohibit some forms of that conduct. This was inspired, at least in part, on the understandable unwillingness of the Government to support a precise statute that would undoubtedly fail to hold all perceived wrongdoers criminally liable. As a result, the Government for the past sixty years has been able to bring cases against anyone it feels has committed a "wrong," despite the fact that Congress has never, as it must, specifically defined the offense.

ARGUMENT

I. THIS COURT SHOULD REJECT THE GOVERNMENT'S INTERPRETATION OF SECTION 10(b) BECAUSE CONGRESS NEVER ENACTED THE MISAPPROPRIATION THEORY AS A CRIME.

The Government's effort to persuade this Court to interpret Section 10(b)[2/] to encompass the misappropriation theory[3/] is a continuation of a long-standing tendency to press upon the courts expansive "interpretations" of Section 10(b) that reach far beyond any boundaries ever contemplated by Congress. Over the past 20 years, the Government has attempted to persuade this Court to interpret Section 10(b) to prohibit mere negligence (*Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976)),[4/] any trading while in

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2/ Both Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, define unlawful conduct: "It shall be unlawful. . . ." A willful violation of Section 10(b) and Rule 10b-5 is a crime by virtue of Section 32(a) of the 1934 Act. 15 U.S.C. § 78ff(a).

3/ The misappropriation theory of liability extends the classical theory of insider trading to outsiders who trade on the basis of material nonpublic information. The theory provides, according to the Ninth and Second Circuits, that Rule 10b-5 is violated when a person:

> (1) misappropriates material nonpublic information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock.

Securities and Exchange Comm'n v. Clark, 915 F.2d 439, 443-44 (9th Cir. 1990) (citing *Securities and Exchange Comm'n v. Materia*, 745 F.2d 197, 201-02 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985)). *Cf. Securities and Exchange Comm'n v. Cherif*, 933 F.2d 403, 410 (7th Cir. 1991) (applying the theory only to breaches of "a fiduciary relationship such as employment").

4/ While the Government was not a party in *Hochfelder*, it submitted an *amicus curiae* brief urging the Court to expand Section 10(b) to cover negligence. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197-99 (1976). Expansions of this type were also rejected in *Aaron v. Securities and Exchange Comm'n*, 446 U.S. 680, 684-86, 691 (1980) (where plaintiffs urged that "fraud" under Section 10(b) meant "negligence"); *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 441, 463 (1976) (where plaintiff asserted that "immaterial" meant "material"); and *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975) (where plaintiffs, supported by the S.E.C. as *amicus curiae*,

possession of material nonpublic information, even where there is no duty to disclose (*Dirks v. Securities and Exchange Comm'n*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980)), and "aiding and abetting" violations of Section 10(b) by others (*Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994)). These attempted expansions of Section 10(b) all failed, not because the Court disagreed with the policies the Government sought to advance, but because the Court adhered to the constitutional principle that Congress must make those policy judgments in legislation it enacts.[5/] Any contrary result would have, among other things, violated the long-standing principle that "[i]t is the legislature, not the Court, which is to define a crime, and ordain its punishment." *United States v. Wiltberger*, 18 U.S. (5 Wheat.) 76, 95 (1820) (Marshall, C.J.).

Under our system of government, Congress enacts statutes to define criminal conduct; there are no common law crimes.[6/] Our Constitution not only entrusts Congress with the power to describe

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suggested that "in connection with the purchase or sale of a security" meant "not in connection with the purchase or sale of a security"). *See also* Milton V. Freeman, *Foreword* to *Happy Birthday Rule 10b-5: 50 Years of Antifraud Regulation Colloquium*, 61 FORDHAM L. REV. S3 (1993) ("I was afraid that [Rule 10b-5] was being subject by plaintiffs, governmental and private, to arguments for expansion to an extent that I believed it was in danger of becoming a loose cannon.").

5/ *See, e.g., Central Bank of Denver*, 511 U.S. at 177-78 ("We cannot amend the statute to create liability."); *Chiarella*, 445 U.S. at 234 ("As we have emphasized before, the 1934 Act cannot be read 'more broadly than its language and the statutory scheme reasonably permit.'") (citation omitted); *United States v. Bryan*, 58 F.3d 933, 945 (4th Cir. 1995) ("For at least two decades, . . . the Supreme Court has repeatedly warned against expanding the concept of fraud in the securities context beyond what the words of the Act reasonably will bear.").

6/ On the contrary, "criminal conduct does not offend against the federal government unless it violates an Act of Congress." *United States v. Mandel*, 672 F. Supp. 864, 873 (D. Md. 1987), *aff'd*, 862 F.2d 1067 (4th Cir. 1988). "[H]owever deserving of punishment his conduct may seem," the federal courts may punish a defendant only if Congress has specifically defined the criminal conduct and authorized the penalty. *Viereck v. United States*, 318 U.S. 236, 243 (1943); *see Jerome v. United States*, 318 U.S. 101, 104 (1943); *United States v. Pardee*, 368 F.2d 368, 374 (4th Cir. 1966). "Federal crimes, of course, 'are solely creatures of statute.'" *Dowling v. United States*, 473 U.S. 207, 213 (1985) (*quoting Liparota v. United States*, 471 U.S. 419, 424 (1985)).

and define what conduct is to be criminal, it entrusts it with the sole responsibility to do so. Where the words of the statute enacted by Congress do not unambiguously delineate the boundary between the acceptable and the criminal, the courts may not step into the breach with a theoretical exegesis of what Congress might have done had it considered the matter.

It is this principle that animates the rule of lenity. As this Court has held, "before one can be punished, it must be shown that his case is plainly within the statute." *Fasulo v. United States*, 272 U.S. 620, 629 (1926) (citation omitted). Where the "text, structure, and history fail to establish that the Government's position is unambiguously correct — we apply the rule of lenity and resolve the ambiguity in [the Respondent's] favor." *United States v. Granderson*, 511 U.S. 39, 54 (1994) (citation omitted). The rule both ensures fair warning of the boundaries of criminal conduct and ensures that it is the legislature that defines criminal liability. *Crandon v. United States*, 494 U.S. 152, 158 (1990); *see also Rewis v. United States*, 401 U.S. 808, 812-13 (1971).

The misappropriation theory bears all the hallmarks of a common law crime. Its grounding in the statutory language is, at best, tenuous. After more than fifteen years of development in the courts, it remains an imprecise theory that prohibits any persons from trading on the basis of material nonpublic information obtained through the breach of some state or common law duty. Even the *amici* supporting the Government acknowledge that the theory is vague, has been developed through case-by-case application in the federal courts, and fails to define with precision the conduct it prohibits.[7/]

The Government and the lower federal courts that have decided to "adopt" the misappropriation theory do not agree among themselves as to what it prohibits. The Government believes the theory applies whenever a person breaches "a fiduciary or similar duty of trust and confidence." *See* Gov't Br.

7/ *See* Brief for Ass'n for Investment Management and Research as *Amicus Curiae* at 3- 6, 11-17; Brief for North Am. Sec. Adm'rs Ass'n and Law Professors as *Amici Curiae* at 2-3, 12-13.

at 12. The Seventh Circuit applies the theory only to breaches of "a fiduciary relationship such as employment." *Securities and Exchange Comm'n v. Cherif*, 933 F.2d 403, 410 (7th Cir. 1991); *see also Securities and Exchange Comm'n v. Maio*, 51 F.3d 623, 631 (7th Cir. 1995). By contrast, the Second and Ninth Circuits prohibit any breach of "a relationship of trust and confidence." *Securities and Exchange Comm'n v. Clark*, 915 F.2d 439, 443-44 (9th Cir. 1990) (citing *Securities and Exchange Comm'n v. Materia*, 745 F.2d 197, 201-02 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985)).

The *amici* supporting the adoption of the misappropriation theory are not unified in their approaches either. One group would impose Section 10(b) liability on any person who "has been entrusted with material nonpublic information and assumed a duty not to use it for personal profit." Brief for North Am. Sec. Adm'rs Ass'n and Law Professors as *Amici Curiae* at 3. Another, conceding the significant uncertainty as to the breadth of the misappropriation theory, would criminalize any disclosure of material nonpublic information "if the disclosure is for personal gain." Brief for Ass'n for Investment Management and Research as *Amicus Curiae* at 3 (emphasis omitted).

Application of these uncertain standards has resulted in some bizarre trends in the enforcement area. Breaches of what were once thought to be private, confidential relationships — such as those between husband and wife,[8/] parent and child, [9/]and doctor and patient[10/] — have been transmogrified into serious federal crimes thereby giving rise to a federal common law crime of

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8/ *See, e.g., United States v. Chestman*, 947 F.2d 551 (2d. Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992); *Securities and Exchange Comm'n v. Lenfest*, 949 F. Supp. 341 (E.D. Pa. 1996).

9/ *See, e.g., Securities and Exchange Comm'n v. Sheinberg*, 1992 WL 372190 (S.E.C. Release No. 13465) (C.D. Cal. 1992); *United States v. Reed*, 601 F. Supp. 685 (S.D.N.Y.), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985).

10/ *See, e.g., United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y. 1990); *Securities and Exchange Comm'n v. Cooper*, 1995 WL 739046 (S.E.C. Release No. 14754) (C.D. Cal. 1995).

"fraud" enforced by the Department of Justice and the S.E.C. Their inquiries into misconduct under the misappropriation theory turn on detailed examinations of these types of private relationships never before subjected to federal regulation. These proceedings illustrate the breadth of, and dangers inherent in, the Government's malleable "misappropriation theory."

Members of Congress have noted these dangers, and have called for a more definitive explanation of the misappropriation theory. For instance, Senator D'Amato, the ranking member of the Securities subcommittee in 1987, recognized that: "it is incumbent upon Congress to confront the basic policy questions of what uses of informational advantage are to be forbidden, rather than leaving the law to be developed on a case by case basis."[11/]

To date, Congress has failed to amend Section 10(b) to describe with more precision the circumstances under which trading while in possession of material nonpublic information is to be prohibited. In an illustrative episode, when Congress was considering the Insider Trading Sanctions Act of 1984, the Chairman of the S.E.C. and the Director of the S.E.C.'s Division of Enforcement acknowledged in their testimony that the current state of the law was so ambiguous that it did not "permit investors to chart their course of conduct confident in their obligations."[12/] Nevertheless, the S.E.C. *opposed* efforts to define insider trading in the 1984 Act, citing its preference for the "flexibility" offered by "case-by-case" determinations, which enabled the S.E.C. to prosecute "evolving types of conduct."[13/]

In 1987, some in Congress once again sought to address the

11/ *Definition of Insider Trading: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, Part I, 100th Cong. 4 (1987) (statement of Sen. D'Amato).

12/ *The Insider Trading Sanctions Act of 1983: Hearing on H.R. 559 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 98th Cong. 35 (1984) (statement of John M. Fedders).

13/ *Id.* at 35, 37. *See also id.* at 38 ("there is no real benefit of clarity of [insider trading] law to investors and the Commission").

misappropriation theory by proposing legislation that would define the unlawful uses of misappropriated information. *See* S. 1380, 100th Cong. (1987). The sponsors' memorandum accompanying the proposed legislation, the "Insider Trading Proscriptions Act of 1987," noted that "the misappropriation theory . . . is itself a judicially-created construct, the parameters of which have never been addressed by either Congress or the Supreme Court."[14/] In connection with congressional hearings in 1987, the S.E.C. proposed enactment of a statute that would have expressly made it unlawful for any person to purchase or sell securities based on material nonpublic information that was "obtained wrongfully," which included information obtained by "conversion, misappropriation, or any other breach of a fiduciary duty, breach of any personal or other relationship of trust and confidence, or breach of any contractual or employment relationship."[15/] Congress chose not to enact this proposal as part of the Insider Trading and Securities Fraud Enforcement Act ("ITSFEA") it passed in 1988.

This history suggests, at most, a statutory ambiguity. Under those circumstances, the courts are not empowered to guess about what Congress meant. The applicable principle is clear: when the Court must choose between "two readings of what conduct Congress has made a crime, it is appropriate, before we choose the harsher alternative, to require that Congress should have spoken in language that is clear and definite." *Williams v. United States*, 458 U.S. 279, 290 (1982) (citation and internal quotations omitted). Any other outcome invites a dangerous intrusion by the Judiciary into Congress' exclusive province of making the laws.[16/]

14/ *See* Explanatory Memorandum accompanying introduction of S. 1380, the proposed "Insider Trading Proscriptions Act of 1987," introduced by Senators D'Amato and Riegel on June 17, 1987, at 2, *reprinted in* 133 CONG. REC. 16,391 (1987).

15/ *The Insider Trading Proscriptions Act of 1987: Hearing Before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs*, 100th Cong. at 28-30 (1987).

16/ *See Dunn v. Commodity Futures Trading Comm'n*, 117 S. Ct. 913, 921 (1997).

The Government and its *amici* urge the Court to step in, lest it leave a purported "gap" in Section 10(b). *See* Gov't Petition for Cert. at 12. The argument is better addressed to the Congress, who created any such "gap" and has the responsibility of closing it.[17/] Policy arguments about the social utility of doing so are matters of legislative concern. As the Congress has recently shown, when the Court finds such a "gap" in Section 10(b), Congress can promptly fill it in the manner Congress decides is most appropriate.[18/]

II. THERE IS NO EVIDENCE THAT CONGRESS INTENDED THAT SECTION 10(b) CRIMINALIZE ALL TRADING ENABLED BY A BREACH OF TRUST OR CONFIDENCE.

Trading on the basis of misappropriated information was not unknown when Congress enacted the 1934 Act. On the contrary, Congress was aware of this phenomenon; the design of the 1934 Act reflects a carefully tailored response, one that does not encompass the misappropriation theory the Government now propounds before the Court, some sixty years later.

A. Congress Was Aware Of The Problem Of Trading On Misappropriated Information, And Chose Only To Prohibit Some Forms Of That Conduct

In 1934, Congress was well aware of the issues surrounding trading on the basis of misappropriated nonpublic information. The hearings that led up to the 1934 Act identified numerous instances "where insiders either personally or through the medium of holding companies participated largely in profits derived from

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17/ "The courts must declare the sense of the law; and if they should be disposed to exercise WILL instead of JUDGMENT, the consequence would equally be the substitution of their pleasure to that of the legislative body." THE FEDERALIST NO. 78, at 526 (Hamilton) (Jacob E. Cooke ed., 1961) (emphasis in original).

18/ In the aftermath of this Court's decision in the *Central Bank of Denver* case, Congress amended the 1934 Act to provide for aiding and abetting liability for Section 10(b) violations, but only in actions brought by the S.E.C.

the use of information not procurable by the investing public." S. Rep. No. 73-792, at 9 (1934). Congress considered these to be "[a]mong the most vicious practices unearthed at the hearings." S. Rep. No. 73-1455, at 55 (1934). They included numerous examples of "the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities." *Id.* The record leaves no room for doubt that insider trading was one of the principal examples of disruptive conduct that Congress sought to regulate through the 1934 Act.

Congress directly addressed some of the problems of trading on the basis of misappropriated corporate information in Section 16 of the 1934 Act. That section was designed to "protect the interests of the public against the predatory operations of directors, officers, and principal stockholders of corporations by preventing them from speculating in the stock of the corporations to which they hold a fiduciary duty." S. Rep. No. 73-1455, at 68.

Section 16 addresses this objective in three separate ways. Section 16(a) imposes public reporting obligations on corporate insiders and 10 percent shareholders, thereby requiring these insiders to disclose any changes in their ownership of the company's securities.[19/] Section 16(c) makes it unlawful for an insider to engage in "short" sales of the company's securities, or to sell "against the box" — transactions in which the insider bets against the performance of his own company.[20/]

19/ 15 U.S.C. § 78p(a). *See* H.R. Rep. No. 73-1383, at 13 (1934) ("the most potent weapon against the abuse of inside information is full and prompt publicity"); *Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong. 134 (1934) (testimony of Thomas G. Corcoran) ("We are simply saying to these men, 'If you are going to sell and get out, be honest about it. Say that you are getting out . . . but do not conceal the fact from your stockholders that you are selling out the company.'").

20/ 15 U.S.C. § 78p(c). In a "short" sale, the insider does not own the securities that he sells; the sale is effected by borrowing the security to make delivery to the purchaser, and subsequently buying an identical number of shares to deliver to the lender. Sales "against the box" are identical to "short" sales, except that the insider owns sufficient securities to cover the sale but nevertheless borrows the security to make delivery. Both

Section 16(b) is explicitly intended to deter trading on misappropriated information, both by insiders (officers and directors) and certain outsiders (10 percent shareholders). The section states that it was enacted "[f]or the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer." 15 U.S.C. § 78p(b). As enacted, Section 16(b) imposes strict liability for such transactions that occur during a six month period. The statute requires the insider to disgorge all profits realized on purchases and sales during this period "without proof of actual abuse of insider information, and without proof of intent to profit on the basis of such information." *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 595 (1973).

Because "the extensive legislative history of the 1934 Act is bereft of any explicit explanation of Congress' intent" concerning Section 10(b), *Hochfelder*, 425 U.S. at 201, there is no legislative history establishing that Congress intended in that section to impose criminal liability on outsiders who trade on misappropriated information. The conscious provision of non-criminal, prophylactic strict liability under Section 16(b) strongly indicates otherwise.[21/] Nor can any evidence of such intent be discerned in the language of the statute.[22/] Section 10(b)'s

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transactions have the same effect: the seller profits or avoids losses if the stock price declines between the time of the initial sale and the time of delivery to the lender. *See* Donald C. Cook & Myer Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 612, 637-38 (1953).

21/ The originally proposed version of Section 16(b) of the 1934 Act, 15 U.S.C. § 78p(b), made a violation into a criminal offense. Donald C. Cook & Myer Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 385, 407 (1953). A subsequent draft of that section eliminated potential criminal liability, because criminal liability for insider trading was seen as "too severe a penalty" for the conduct at issue. *Id. See also Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232, 248 n.23 (1976).

22/ Even if this were not true, the language of Rule 10b-5 was also not intended to cover misappropriation. Rule 10b-5 was a hastily-prepared administrative response to a single incident of perceived intentional conduct by a corporate insider without any consideration of misappropriation by outsiders. *See Conference on the Codification of the Securities Laws*, 22 BUS. LAW. 793, 922 (1967) (remarks of Milton V. Freeman, one

prohibition on "deceptive" devices employed "in connection with" a securities transaction does not readily lend itself to a prohibition on misappropriations of information in circumstances not involving deception of a party to the securities transaction.[23/]

The history of Section 10(b) reflects this reality. For years, Section 16 represented the entire scope of regulation of insider trading under the 1934 Act. Almost thirty years after Section 10(b)'s enactment, the S.E.C. determined that Section 10(b) and Rule 10b-5 barred trading by insiders or their affiliates on the basis of nonpublic corporate information because of the special duty owed by corporate insiders to shareholders. *See In the Matter of Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). The reasoning of *Cady, Roberts* is telling, for the S.E.C. justified the application of Section 10(b) and Rule 10b-5 based upon a disclosure duty flowing from the special relationship between the buyer and seller in the transactions at issue, which gave the shareholder the right to all material information known by the insider before making an investment decision. *See id.* at 911-13. If the misappropriation theory was believed to fall squarely within Section 10(b) when *Cady, Roberts* was decided, the duty of the insider to the shareholder would have been irrelevant and the ascension of the disclosure duty as the touchstone of insider trading law would never have occurred.

Thus, history shows that the Government's misappropriation theory arises not out of the language of the 1934 Act, or the legislative intent of Congress, or even the commonly understood scope of the statute in the years following its enactment. It arises instead out of what the Government considers a "gap" in what *should be* prohibited — a gap that flows from the very framework of Section 10(b) that the S.E.C. itself recognized in *Cady, Roberts*. That framework has been the foundation for this Court's jurisprudence regarding Section 10(b) for many years.

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of the Rule's co-drafters).

23/ *Cf. Dirks*, 463 U.S. at 656 (rejecting S.E.C. position that "anyone who knowingly receives nonpublic material information from an insider has a fiduciary duty to disclose before trading").

In its decisions applying Section 10(b)'s application to insider trading, this Court has drawn the line at classical insider trading — where an insider or his affiliate commits "deception" by trading with a person to whom he owes a fiduciary duty, without disclosing material information he knows. *See Chiarella*, 445 U.S. at 234-35; *Dirks*, 463 U.S. at 654. As in the S.E.C.'s first consideration of this issue in *Cady, Roberts*, these cases turn on the presence or absence of a duty to disclose flowing between the parties to the transaction. *See Chiarella*, 445 U.S. at 230 ("such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction"); *Dirks*, 463 U.S. at 657-58. As the briefs of the parties and lower court decisions discuss at length, the Court's reasoning in those cases will not encompass the much broader misappropriation theory, which imposes liability on outsiders who misappropriate information, and then use that information in transactions with people that have no reasonable expectation of disclosure and who are not named in the indictment among the injured parties.

B. Congress' Actions Since 1934 Have Not Altered The Scope Of Section 10(b)

The suggestion by the Government and its *amici* that, more than fifty years after passage of the 1934 Act, "Congress confirmed the validity of the misappropriation theory of liability, when it bolstered sanctions for insider trading" is both unavailing and untrue.[24/] Their entire argument rests on a remedial provision in legislation that expressly disavows any intent to alter the scope of Section 10(b), and inconclusive snippets from legislative debates. Ironically, the full record of Congress' consideration of the misappropriation theory since its creation in 1981 refutes the Government's argument, by demonstrating that Congress in fact *declined* to amend the 1934 Act to criminalize trading on misappropriated information, and that it did so at the S.E.C.'s urging.

24/ *See* Gov't Br. at 32-33; Brief for North Am. Sec. Adm'rs Ass'n and Law Professors as *Amici Curiae* at 16-27.

The Government's first argument is that Congress' amendment of the securities laws since the birth of the misappropriation theory in 1981 demonstrates tacit approval of that theory. Gov't Br. at 32-35. But this Court has routinely rejected that interpretive approach, holding that Congress' amendment of one provision in a statute does not mean that it has acquiesced in the courts' interpretation of another provision.[25/] A consistent judicial construction may be incorporated when Congress reenacts the statutory language at issue, but "Congress has not reenacted the language of § 10(b) since 1934, however, so we need not determine whether the other conditions for applying the reenactment doctrine are present." *Central Bank of Denver*, 511 U.S. at 185. Moreover, in the remedial provision cited by the Government, Congress specifically directed that it was not intending to alter the underlying criminal offense. *See* 15 U.S.C. § 78t-1(e) ("Provisions not to affect public prosecutions").

The government also argues that portions of the legislative debate over ITSFEA demonstrate Congress' agreement that Section 10(b) encompasses the misappropriation theory of liability. *See* Gov't Br. at 33-34 and n.18. That approach to statutory interpretation has also been rejected by the Courts. "[T]he interpretation given by one Congress (or a committee or Member thereof) to an earlier statute is of little assistance in discerning the meaning of that statute."[26/] Moreover, there are a number of more direct and contrary statements in the legislative

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25/ "Congress may legislate . . . only through passage of a bill which is approved by both Houses and signed by the President. . . . Congressional inaction cannot amend a duly enacted statute." *Central Bank of Denver*, 511 U.S. at 186 (*quoting Patterson v. McLean Credit Union*, 491 U.S. 164, 175, n.1 (1989)). *See also Rivers v. Roadway Express*, 511 U.S. 298, 313 (1994) ("Congress . . . has the power to amend a statute that it believes [has been] misconstrued [by the courts]. . . . No such change, however, has the force of law unless it is implemented through legislation."); *McNally v. United States*, 483 U.S. 350, 352-60 (1987); *Aaron*, 446 U.S. at 694 n.11 ("[T]he failure of Congress to overturn the Commission's interpretation falls far short of providing a basis to support a construction of § 10(b) so clearly at odds with its plain meaning and legislative history.").

26/ *Central Bank of Denver*, 511 U.S. at 185-86 (*quoting Public Employees Retirement Sys. v. Betts*, 492 U.S. 158, 168 (1989)); *see Weinberger v. Rossi*, 456 U.S. 25, 35 (1982); *Consumer Product Safety Comm'n v. GTE Sylvania, Inc.*, 447 U.S. 102, 118, and n.13 (1980).

record. For example, in passing ITSFEA, the House committee was careful to state that "the Committee does not intend to alter the substantive law with respect to insider trading with this legislation," H.R. Rep. No. 100-910, at 11 (1988).

In the end, the arguments of the Government and *amici* regarding congressional acceptance of the misappropriation theory emphasize the one thing that has never occurred. Congress has never passed, and the President has never signed, legislation that states that the conduct of Mr. O'Hagan in this case is unlawful and should be subject to criminal prosecution, as well as S.E.C. civil law enforcement prosecutions. Because *that* is what is required to designate activities criminal, the arguments of supposed congressional acquiescence in other forms fail.

CONCLUSION

Twice before, the Government has come to this Court with theories of misbehavior that it has attempted to shoehorn into the statutory language and history of Section 10(b). Twice, this Court has rebuffed those attempts. The misappropriation theory is the Government's most recent effort to expand the scope of Section 10(b). The theory is nothing if not a clever exercise in formal logic and linguistics. But one cannot lawfully be convicted of a federal crime for violating a plausible theory of what a statute may mean. Rather, the Courts must be able to discern, from the language chosen by Congress to describe its prohibition or from the circumstances of the law's enactment, an exercise of political will to criminalize the course of conduct encompassed by the theory. The misappropriation theory does not meet this standard.

For the foregoing reasons, we respectfully urge the Court to affirm the judgment of the court of appeals.

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